



Real
Instituto
Elcano

de Estudios Internacionales y Estratégicos

**YEARS OF LIVING DANGEROUSLY: FROM THE
TWIN DEFICITS TO THE BALANCE OF FINANCIAL
TERROR?**

Paul Isbell

Working Paper (WP) 28/2005

1/6/2005

Years of Living Dangerously: From the Twin Deficits to the Balance of Financial Terror?

Paul Isbell *

Summary: The US's large and growing current account (or 'external') deficit, together with its significant government budget (or 'internal') deficit, has begun to place real limits on future US growth. Is current US growth sustainable in light of these 'twin' current account and government budget deficits? (*Derived from, and based upon, a presentation given at the Casa de América in Madrid on 28 February 2005 in the Seminar 'Tendencies in US Policies for the Next Four Years'*)

US Growth and the 'Twin Deficits': Are They Sustainable?

Economic growth in the US has been relatively impressive during the last two years and is now moving forward at about 3.5% a year. While employment growth has been the weak leg in the US recovery from the 2001 recession, there are some recent if not yet altogether conclusive signs that employment may be picking up again in a broad and sustainable fashion. Nevertheless, the US's large and growing current account (or 'external') deficit, together with its significant government budget (or 'internal') deficit, has begun to place real limits on future US growth.

Is current US growth sustainable in light of these 'twin' current account and government budget deficits? If these deficits themselves are sustainable, then, yes, we would conclude that US growth is also currently unfolding upon a stable foundation –at least in the short and middle run–. Perhaps it would be easier then to ask whether or not the current account deficit itself is sustainable? Unfortunately, our answer is no. Once this is established, the only real questions that remain to be answered are: (1) at how high a level –and for how long– can the external deficit be maintained? Put in other words, when will the inevitable correction begin? Will the adjustment occur within George Bush's second presidential term? Or only after the next presidential election? Furthermore, (2) what will be the consequences of this ultimate readjustment of the current account? Will the correction be severe or mild? Will the US –and the world– economy experience a significant recession, or a mere soft landing? Finally, (3) what will be the implications for US domestic and foreign policies, and for the economic and political responses from the rest of the world?

The Scope and Nature of the External Deficit

In 2004 the US's trade deficit finished the year at a record US\$612bn, while the current account deficit (a slightly broader account of the external position) ended up at US\$670bn, or some 5.7% of GDP. This was the largest absolute and relative level of external deficit registered by any advanced economy in recent times. Meanwhile, the government's fiscal deficit, even during a year of strong economic growth, came in at US\$412bn (or 3.6% of GDP), much of which was the result of the Bush administration's tax cuts enacted during the previous years. An increasing amount of debate now revolves around the causes of

* Senior Analyst, International Economy & Trade, Elcano Royal Institute

these deficits and their implications, not only because of their unprecedented nature and international reach, but also because each particular explanation implies a very distinct set of conclusions for US and international policy.

Some analysts have focused on the ‘twin’ nature of the deficits, arguing that loose fiscal policy directly feeds the current account deficit by stimulating consumption growth and imports. Beyond that, however, government borrowing to finance the fiscal deficit increasingly has been forced to rely on foreign savings channelled to the US by foreign investors whose ongoing interest receipts not only make the US fiscal burden heavier but also constitute outflows on the current account in the future, contributing to an ever wider external deficit. Meanwhile, the widening current account deficit requires –and, it is hoped, will continue to attract– ever more inward finance, which is easily channelled into US government debt, either through the primary market (increasing the fiscal burden) or through the secondary markets (keeping interest rates relatively low and further encouraging ever more consumption and imports). This argument, therefore, focuses on the need to reduce US government deficits and borrowing, a primary cause, in its view, of the external deficit. Of course, this is an uncomfortable conclusion for many Americans, as it implies the need to either raise taxes or cut spending, both of which are politically sensitive propositions. Either or both such policies would certainly imply slower growth for the US, possibly provoke political backlashes from distinct and competing constituencies and unleash a bloody political fight over the direction of US foreign policy, its financing, and the prioritisation of the concomitant sacrifices.

Others experts question the link between the two deficits, arguing that fiscal deficits and current account deficits have not always moved in parallel in recent history.¹ Furthermore, this argument also claims that the primary cause of the US current account deficit is the relative attractiveness that the US economy offers to foreign investors channelling international savings. The buoyant US economy, superior to other major economies in terms of productivity growth and expected future returns, therefore acts as a magnet for world savings, keeping, in turn, US interest rates low and feeding US consumption which, for its part, serves as the world’s only stable growth engine.² While this view concedes that US fiscal policy should be gradually, if prudently, restrained, it also places more emphasis elsewhere, primarily on the imperative for other major economies to make essential adjustments to increase their own domestic demand and reduce their level of excess savings, so as to take on some of the burden for world growth.

This view attempts to deflect the debate away from the fiscal and foreign policies of the Bush administration and instead focuses upon the economic and foreign policies of Europe and Asia. According to this view, Europe still requires significant economic reform in order to make its economy more flexible and, therefore, capable of generating more domestic demand and imports from the US. Asia, for its part, must allow its exchange rates to appreciate in order to take pressure off the US trade deficit. This point of view sees it as misguided to focus on Bush’s fiscal and foreign policies as the main factors behind US deficits –after all, the US has shouldered the twin burden of providing demand for an anaemic world economy and essential security for the world system–. Instead, the primary problem resides in the misguided policies of Europe and Asia that undermine domestic demand and force these economies to rely upon US-supported export growth. Such a view places the burden for the more difficult and challenging political adjustments on those who generate the world’s excess savings.

On the other hand, both schools of thought –while differing significantly in the evaluation as to the immediacy of the coming adjustment– do acknowledge that an adjustment, or some sort, will need to take place. While there are also different views on the most likely pattern of adjustment –smooth and relatively painlessly versus abrupt and potentially messy– there is, nevertheless, a consensus on the need for the dollar to depreciate further. The real effective exchange rate of the dollar has depreciated between 15% and 20% since its last peak in 2002, but there is broad agreement that for the current account deficit to decline to more sustainable levels (between 2.5% and 3% of GDP), a further 15% to 30% real effective depreciation will be required.³ Because the dollar has already depreciated significantly against the currencies of most advanced economies, including a partial correction against the Japanese yen, this means that the most efficient dollar depreciation should occur against the export-sensitive currencies of continental Asia, particularly the Chinese yuan.⁴ However, many do acknowledge the potential for currency overshooting, even against the export-sensitive euro, making this process of adjustment highly politically charged and technically tricky.

Nevertheless, the current account deficit remains a palpable and daily fact –and there are no clear signs that the dollar depreciation that has occurred to date has made the slightest impact upon it–.⁵ The most recent monthly trade deficit figures from the US show the deficit reaching record levels, on track to finish 2005 well over US\$700bn. Some analysts, like those at the OECD, have estimated recently that the external deficit could reach US\$900bn (or 6.7% of GDP) in 2006.⁶ One comment that has constantly been made in the press –to underline the scale of the external deficit and the foreign financing needed to maintain it– has been the need for the US economy to import over US\$1.8bn of capital everyday. On an average net basis this is true. However, even this oft-repeated fact deserves some closer inspection, for it hides from view the fact that, in *gross* terms, the US must import at least US\$3.6bn a day. If we think further in terms of only working days, the *net* requirement is nearly US\$2.8bn per day, far more than the figure so often repeated.

Furthermore, the level of US net external obligations (or its net international investment position, generated from past accumulation of current account deficits) is now estimated to be over US\$3 trillion, or approaching 30% of GDP.⁷ The resulting net outflow of interest, dividend and other profit payments on these obligations is now estimated to be equivalent to about 30% of the current account deficit every year, and this is likely to continue to grow. Even should the trade deficit remain constant in relation to GDP, current net external obligations will have to be paid (and financed as well), a process which by itself would widen the current account deficit over time. The OECD has estimated that even ongoing deficits of only 3% of GDP –about half the current levels– would bring the US net international investment position (or NIIP) to 40% of GDP by 2010, eventually stabilising at about 63%. Should the external deficit remain at current levels, the OECD estimates that the NIIP would reach 50% of GDP by 2010 and eventually 100%. Our own estimates – which correspond to those of many other economists– are that, assuming 4% growth in the US economy indefinitely into the future, along with current trade deficit levels, the NIIP will reach some 57% of GDP by the end of 2008.⁸ The growing fear is that international investors will become increasingly sceptical about continuing to finance a US current account deficit that is feeding an unsustainable rise in US net external obligations, provoking a severe dollar crash, a subsequent spike in US interest rates and a painful world recession.

The Sources of the Deficit

But what exactly is generating the current account deficit? Or, to put the question another way, is the required foreign borrowing financing investment or consumption? And is such borrowing being undertaken by private or public agents? At the height of the 1990s boom (mid-1998), the US current account deficit remained a modest 1.5% of GDP. But as the boom progressed and the external deficit grew, the latter was being generated by an increase in investment spending. Meanwhile, the primary agents behind the necessary borrowing were private sector actors. Public savings actually increased, as the government's budget was moving into surplus. According to the so-called Lawson Doctrine –which identified a current account deficit as dangerously unsustainable only if it were generated by excessive consumption spending and financed by government borrowing– there was no particular problem with the growing US current account deficit in the 1990s –just as Nigel Lawson himself saw no great danger in the British current account deficit during the mid-1990s⁹–. Catherine Mann, a senior fellow at the Institute for International Economics in Washington, and an expert in the dynamics of the US current account, has likened such foreign borrowing on the part of the US during the 1990s to the astute student who takes out student loans to pay for tuition and buys books with a credit card. It is the investment nature of the spending in question –at least theoretically capable of contributing to a future stream of income much higher than in its absence– which justifies the increased indebtedness required to finance it.

However, this decade's US external deficit has acquired an entirely different, and more questionable, character. The macroeconomic policy responses to the recession of 2001, including the rapid drop in interest rates to the lowest levels in half a century, along with the rapid deterioration of the government's budget surplus (some 2% of GDP) into a large and growing deficit (nearly 4% of GDP), not only transformed the nature of the spending financed by the US's foreign borrowing, but also changed the quality of this borrowing itself.¹⁰ When investment spending collapsed in the wake of the bubble, consumption remained strong, in response to cheap money and easy mortgage refinancing. Meanwhile, as a result of the Bush administration's three successive tax cuts (2001, 2002 and 2003), the government became the economy's largest net borrower, dwarfing the impact of borrowing from the private sector that was instead busily rebuilding balance sheets and increasing the level of net private corporate savings. Furthermore, the current account deficit, traditionally expected to move down towards balance during a slowdown or recession, did not adjust at all. On the contrary, it continued to increase relative to the GDP, moving from 4.5% in 2000 to 5.7% in 2004. Furthermore, the unrestrained tendency to borrow from abroad was no longer generated by strong levels of productive investment spending but rather by private household and (increasingly) government consumption. Mann likens this behaviour to that of the carefree student who drops out of school and decides to pass the time on a Caribbean beach instead, putting all such expenses on his credit card.

But as the Fed continued to keep interest rates depressed at historically low levels, consumers were able to continue financing their consumption binge by borrowing against inflated asset values. The boom in housing prices, unleashed by the Fed's historic cheap money policy, allowed for at least three successive waves of mortgage refinancing, producing fresh wads of cash for consumption spending. Nevertheless, the increased debt level implied by mortgage refinancing would remain fixed, even despite a future likely drop off in housing prices, once consumers –or bank lenders– lost their nerve and refused to continue to borrow and buy –and certainly once the Fed began to raise interest rates

again—. Therefore, we liken such borrowing behaviour, increasing the current account deficit still further, not to the drop-out who would merely finance his Caribbean holiday on credit, but more to the drop-out who not only uses his credit card to get him to Vegas, but also to stake his gambling spree.

But the true nature of the US current account deficit is even scarier. The current account has moved from 1.5% to nearly 6% of GDP in seven years, while the fiscal position has slipped from a 2% surplus to a deficit of over 4% of GDP in even less time. The current account, while widening, has transformed from an investment to a consumption affair, while the principal borrower has changed from the private sector –presumably bound to make the correct decisions within the context of a functioning market– to the state. Furthermore, while it is clear that foreign ownership of US assets is becoming increasingly pronounced –foreigners owned only 20% of outstanding US Treasuries in 1990, compared with nearly 50% today– it is less and less the foreign private sector that has continued to extend fresh funds to the US. While inward flows of private FDI have softened noticeably (from US\$300bn in 2000 to US\$30bn in 2003 and US\$100bn in 2004), official –or public– foreign financing of the US current account deficit has largely taken over from the private sector. During the last two years, upwards of 80% of the US current account deficit was financed by the reserve intervention policies of the world’s central banks, with Asian central banks alone contributing as much as 80% of this (or some 60% of the total). China’s central bank alone financed nearly a third of the US current account deficit in 2004.

So borrowing to finance investment has become borrowing to finance consumption. Private consumers, meanwhile, have been joined by the government in the borrowing and spending binge. Crucially, however, private sector lenders have increasingly abandoned the field –even as US growth rates have bounced to above 4% in 2003 and 2004, after the doldrums of 2001 and 2002– and ceded the terrain to official public actors, principally the world’s central banks. What is more, the bulk of this new official-sector lending is concentrated in Asia. While much of this financing has been extended by the US’s strategic allies (Japan, South Korea and Taiwan), by far the most dynamic central bank lender has become China, a rival that the US frequently accuses of unfair and manipulative trade practices, widespread human rights violations, aggressive bullying of its neighbours and behaviour which, when it does not condone international terrorism, certainly does not help to eliminate it. To make matters even worse, central banks have recently begun to diversify the types of assets in which they invest their growing reserves. While US treasury bills and bonds have traditionally been the asset of choice for reserve managers, there is evidence of a recent shift towards other less traditional forms of debt, like agency paper or –even more disconcerting– higher yield, higher risk assets like US mortgage-backed securities. So the Chinese authorities, by way of financing the US current account deficit, are now investing in the US housing market bubble... what next?

This scenario is even more unstable than that of the dropout cut loose in the casinos of Las Vegas with only his credit card. He has now exceeded his traditional credit limits and squandered all of this available credit at the roulette wheel. Rather than quitting and getting a job so as to generate income to pay down his debt, he has borrowed still more money on the black market from the Mob. While the interest rates he is forced to pay remain lower than with the typical loan shark, this is only because he has befriended that Mafioso’s son who is secretly lending him funds drained from his father’s accounts, so that our friend can continue to feed his bad habits at the casinos. Short of a miracle, can this

story end in any other way but bad? It is true that the nature of the relative power relations between our gambler (the US) and his new found unconventional creditor (China) are more balanced and symbiotic than in this simplified example. Nevertheless, it is clear that the scale and nature of US spending and borrowing has undergone a profound transformation that will have important implications for world macroeconomic stability and international geopolitics.

Apologies for US Deficits

Throughout 2004, economist after economist warned of the unsustainable nature of US deficits. Robert Rubin, Larry Summers, Kenneth Rogoff, Wynn Godley, Stephen Roach, Martin Wolf, Fred Bergsten and Catherine Mann are just a few of those who have attempted to sound the warning.¹¹ Former Fed Chairman Paul Volcker even declared that there was, by late 2004, a 75% chance of a dollar crisis within the next five years. The IMF has also warned of the same dangers in its official publications, both in 2004 and 2005, advocating immediate fiscal policy tightening in the US and arguing that the recent Bush tax cuts threaten to undermine the economy's fiscal solvency and possibly a dollar crisis.¹² The OECD recently contributed to the warning, publishing its forecast in May that the US current account deficit would continue to rise in 2005 (to 6.4% of GDP) and 2006 (to 6.7%), and calling on the ECB to lower interest rates so as to stimulate Euro area domestic demand to help check this dangerous trend.

Even Alan Greenspan acknowledged, in the fall of 2004, that the current account deficit could not be expected to continue to widen indefinitely without repercussions: foreign investors' appetite could easily begin to wane. Greenspan's apparent confirmation of what by last November had become an increasingly loud chorus of warnings from a wide range of respected economists and economic commentators set off a dollar slide which became especially pronounced in the last days of December and early days of January. Not only did the euro rise to nearly US\$1.36, but most other major world currencies –with the key exception of the Chinese Yuan– also registered notable appreciation. This dollar depreciation combined with news of record US deficits in 2004 to provoke a string of analyses in early 2005 which take issue with the most alarmist version of the story (most clearly represented by Nouriel Roubini of NYU and his colleague, Brad Setser) and bring into question the severity of the US external deficit and the likelihood of a disruptive adjustment process leading to a hard landing.

Some of the most sophisticated responses have come from important figures at the US Federal Reserve, including Greenspan himself, Ben Bernanke and Roger W. Ferguson, Jr.¹³ These analyses, although slightly different in their emphases, argue that the US current account deficit is not as destabilising as many presume. Briefly put, they argue that structural changes in the global economy tend to allow US deficits to grow to a larger degree than has traditionally been believed feasible or sustainable. What is more, these structural changes provide mechanisms which will likely make the ultimate adjustment of the current account deficit gradual and orderly.

Greenspan's talk, while touching upon the arguments which have subsequently been picked up by his colleagues, focused on the imminence of the adjustment to the trade deficit which he saw as just around the corner by the end of 2004. His argument, when answering the question as to why the current account deficit had continued to widen despite the significant dollar decline against most of the currencies from the developed world

(particularly the euro, the pound sterling and the other ‘Commonwealth’ currencies) since early 2002, was that foreign exporters had been squeezing the profit margins in 2002 and 2003 so as to maintain US market share. Such behaviour, which repressed the exchange rate pass-through effect on the dollar prices of US imports, had short-circuited the current account adjustment process stemming from dollar depreciation. He nevertheless saw evidence of this process coming to an end during 2004, as foreign exporters began to abandon such a strategy as profit margins reached the low limit of sustainability. This change would presumably mean that higher profit margins for foreign exporters would lead to higher US import prices. Nevertheless, it would appear that such an argument would imply that: (1) the normal J-curve dynamic had not yet begun to play itself out, implying even further delays in the current account adjustment; and (2) only further dollar depreciation against these currencies would produce the desired pass-through effect and resulting downward adjustment of US imports. The open question is, however, not only whether the dollar should decline further against these ‘Western’ currencies, but also whether it will.¹⁴

The arguments of Ben Bernanke and Roger Ferguson are more varied, but coalesce around the claim that the US current account deficit stems not from the US budget deficit, or a growing shortage of US savings, but overwhelmingly from a savings glut in rest of the world as a result of insufficient domestic demand in other economies, from the significant productivity growth differential between the US and others, and from globalisation’s impact on reducing the home bias of international investors (who now bring their funds to the US market more readily than in the past). This boils down to the claim that the US external deficit has become so large by relative and historical standards not because of excessively imprudent US spending and indebtedness but rather because of the enormous attraction that the US economy holds for international capital flows in the context of open and globalised capital markets and weak domestic demand in the rest of the world.

The basic conclusion of these arguments coming from the Fed representatives is that the unprecedented nature of US deficits should not give cause for unprecedented levels of concern. We are simply operating on a level of economic reality with no historical precedent and therefore past criteria do not hold the same relevance that they might once have had. One of the important implications of this position is that the growing US budget deficit plays little if any role in the growing current account deficit. Indeed, the claim is made that even if the budget deficit were eliminated tomorrow, this would have only a marginal impact on the current account position. Part of the argument here is that government dissavings since 2000 have not crowded out net exports but rather private spending (private consumption and business investment) and have been to a large degree offset by a build-up in private savings. The implication here is that without the Bush fiscal expansion, the build-up in private savings would not have taken place and the continued private spending trends would have bloated the current account deficit to nearly the same current levels. The upshot is that the culprit is not Bush’s fiscal policy at all –although all the Fed authors are careful to claim that fiscal consolidation would still be positive, but on other independent grounds– but rather the changes wrought by economic globalisation and the varying degrees of ease (the US economy) and strain (Europe, for example) which different economies around that world have experienced in adjusting to such changes.

One is still uncomfortable with this line of argumentation, however. First, the build-up in private savings was mainly a corporate phenomenon which occurred primarily in 2001 during the fallout of the boom (stock market decline, dot.com crash and corporate

scandals) as companies sought to shore up their balance sheets. The build-up in private household savings has been minimal and levels remain historically low (in February Greenspan said the personal savings rate was 1%, although in April Ferguson claimed it was less than 2%). Furthermore, the private sector savings rate (including both corporations and households), after recovering somewhat during the recession to just under 15% of GDP, has been constant since 2002 –according to the very same data used by the Fed simulation study cited by Ferguson– even as the budget deficit and the current account deficits have continued to widen.

Do we really believe that without the growth in the budget deficit both private households and corporations would have continued to save less and to go further into debt, thus maintaining US growth and the expansion of the current account deficit? Or is it not more plausible that without the fiscal and monetary expansions since 2001, private households and corporations would have contracted their spending even more and built up their savings to even higher levels, with the accompanying result being a steeper and longer recession?¹⁵ A steeper and longer recession no doubt would have had a corrective effect on the current account deficit. Could it be that if the current account deficit is to be sustainable at higher levels than previously imagined, and for longer periods of time, this would ultimately depend on maintaining US growth at high levels, based on the mirage of unsustainable fiscal and monetary expansions? Now that the monetary expansion is subsiding, can US growth continue at such buoyant rates? Can fiscal expansion continue, and can it be sufficient to continue to underpin growth, particularly in light of the potential impact of monetary tightening on the housing market and levels of household consumption? Could it possibly be that case, as Bernanke and Ferguson imply, that if indeed the budget deficit were to be eliminated tomorrow, the effect on the current account deficit would be nil? Why would this be so? Because the private sector (who? households? corporations?) will suddenly kick in with a renewed burst of spending and a concomitant draw down in the private savings rate? Were not the Bush tax cuts –arguably responsible for much of the fiscal deterioration– justified as a way to stimulate both consumption and investment spending? Would a reversal of the Bush tax cuts or a significant slashing of public spending stimulate corporations and households to spend more?

We find this difficult to believe, to say the least. Either growth will have to subside, taking pressure off the external deficit, or the external deficit will eventually provoke a slowdown, soft or hard. Monetary policy has begun to tighten, sensibly, even if it means potential economic pain. At least, prudence in the face of potential renewed inflationary pressures has held the day. Will the administration follow suit with fiscal policy in the face of potential limitations on the horizon? In the end, these Fed-based analyses seem to assume that the growth pattern of the US since 2000 would have been the same with or without fiscal and monetary expansion and that therefore macroeconomic policy has had no impact on the external deficit. This would appear to ignore the reality of the cleansing effects of recession –after a period of borrowing excess– that lay the foundation for a sustained period of stable growth in the next phase of the cycle. If we can indeed ignore this assumption, then we are truly well into virgin territory. But remember that technology did not, in the end, slay the double-headed dragon of inflation and the economic cycle. Are we really to believe that globalisation has now deactivated the limits that external deficits place on growth? Talk of new paradigms is typically a dangerous sign that a long cycle is about to break.

However, there is an aspect of these arguments from the Fed that does seem credible. If the whitewashing of the role of fiscal and monetary policy seems questionable, the arguments concerning the rest of the world should not be ignored completely. Pointing to the role that growth and productivity differentials play in creating a bias towards current account deficits and surpluses is useful in that it clarifies the role that other economies have in the development of the world's current macroeconomic imbalances and thus implicates them in contributing to a smooth adjustment process. This is particularly important should global economic coordination prove necessary to minimise the global impacts of the adjustment process and if there is to be any chance of equitably distributing the resulting policy and economic burdens. However, this positive effect is undermined by the insistence that US macroeconomic policy has had, and continues to have, no necessary role to play in this process.

There is also another set of arguments that has recently surfaced to minimise the importance that many place on the scale of the current account deficit and the risks of a hard landing for the dollar. These arguments focus on the potentially dangerous build up of net external obligations that the US economy must carry as a result of lasting and growing external deficits. The estimates of the OECD mentioned above, for example, that foresee the US's negative NIIP quickly moving beyond 50% of GDP and even to 100% in the future suggest that even the normally attractive US economy might begin to lose its allure to foreign investors, who are likely to become increasingly wary of the continued sustainability of growing current account deficits and the potential for a dollar rout.

A new school of thought –while not dealing directly with the role of US fiscal deficits– argues that if we account for the effects of dollar depreciation on US-held foreign assets, the deterioration in the NIIP as a result of continued current account deficits is not as severe as one would think from the calculations of the NIIP using the historic book value of assets. As a result, while the current account would adjust as a result of dollar depreciation, adjustment would also occur via the financial channel as depreciation increased the dollar value of US foreign assets dominated in other currencies. This could possibly imply that the level of dollar depreciation required for sustainable adjustment would be less significant than traditionally assumed, allowing the sustainable current account deficit to be higher than previously thought. Some have therefore argued that the euro, for example, need not fall any further to achieve adequate adjustment against the dollar.¹⁶

Such an argument might be valid in the case of a current account adjustment through a gradual depreciation of the dollar, similar to that which has occurred against the euro. The implication is only that the negative NIIP will grow more gradually than previously assumed with any particular level of current account deficit, and that the dollar adjustment necessary will be less intense, allowing for a sustainable level of the current account deficit to be higher than previously imagined. This might make sense for analysis of euro-dollar dynamics, suggesting that the dollar has depreciated sufficiently against the euro and that the US-European bilateral current account has, or will, adjust to sustainable levels. But it says nothing about the principal drivers of the current account deficit –the position *vis-à-vis* Asia–. Asian currencies on the whole have only adjusted in a minor way against the dollar, and the current account deficit *vis-à-vis* Asia continues to grow.

As we will see below, this situation is maintained, at least in part, by the fixing of the yuan against the weaker dollar, and the desire of most Asian economies to attempt to limit their

currency appreciation. To do this has required large-scale currency intervention and a recycling of Asia's dollar reserves to the US, financing US fiscal and current account deficits. The arguments of both the Fed representatives and this NIIP school of thought assume that private foreign investors continue to view US assets as superior to those in other economies and therefore are willing to finance much higher US deficits for much longer periods of time than in the past. However, both sets of arguments ignore the fact that in recent years official state actors –central banks– have largely taken over from private investors the role of financing US deficits. In this context, it is difficult to argue that US deficits are sustainable –ie, will not provoke a growth slowdown– or that that correction will be necessarily orderly and mild. If foreign central banks decide to slow the rate of dollar accumulation and investment in US assets, the correction could be severe. And if private investors can see what central banks see, there is little reason to believe that they would step in to fill the gap –regardless of the arguments that in the long-run the superiority of the US economy and capital markets will continue to attract, all other things being equal, world savings–.

Nevertheless, there are also those who argue that US borrowing from Asian central banks to finance consumption keeps Asia expanding on the basis of export-led growth which, in its turn, generates the excess savings and therefore the capacity to finance US consumption. This symbiotic relationship is deemed by those who defend it not only to be beneficial but also sustainable –at least the middle run, if not in the long run–. Indeed, for such voices this relationship represents, once again, a new paradigm in which many of our traditional criteria for external deficit sustainability simply do not apply.

New Paradigm or a Balance of Financial Terror?

As the dollar has weakened under the weight of the US current account and government budget deficits, many voices in the US (and some in Europe) have called for the revaluation of the 'undervalued' yuan. The claim –widespread among the US political elite– that the Chinese are engaging in outright 'currency manipulation' by actively maintaining an undervalued exchange rate has gained in credence and plausibility – particularly among US middle class voters– as the Chinese bilateral trade surplus with the US (now some US\$170bn and nearly a third of the overall US trade deficit) continues to grow and as manufacturing employment in the US fails to recover convincingly.

Official US pressures on the Chinese to revalue, spearheaded by Secretary of the Treasury John Snow and echoed by the G7's periodic declarations, were particularly intense during 2003. Most US estimates claim that the yuan remained 10% to 25% undervalued. Many voices even called for a quick and complete liberalisation of China's capital account and an immediate free float of the yuan. In 2004, however, such pressures largely subsided as it became apparent that the simple, radical solution advocated by the Bush Administration could not realistically be expected from the Chinese authorities, nor could it be considered a problem-free solution for the US. Grudgingly, as the presidential election campaign unfolded, it was quietly recognised within Bush circles that the Chinese currency intervention required to prevent yuan appreciation was also providing the key external financing for the growing budget and current account deficits (particularly after the Japanese terminated their large-scale currency intervention in April 2004) and was perhaps even providing for a significant, if invisible, subsidy to US consumption.

Asian Reserve Accumulation

While the US continues to import large volumes of Asian manufactured imports – facilitated by a dollar unable to depreciate against the yuan and many other Asian currencies– the concomitant Asian reserve accumulation has been to a large degree invested in US Treasuries –at least up to the present– providing a key flow of external financing for the growing budget and current account deficits. While total world foreign exchange reserves nearly doubled from US\$2,290bn at the end of 2000 to approximately US\$4,000bn at the end of 2004, well over half of this accumulation has occurred in Asia. Asia now holds nearly two-thirds of global foreign exchange reserves (some US\$2,660), and most of this is found in East Asia. The People’s Bank of China alone increased its reserves by over US\$200bn in 2004, financing nearly a third of the US current account deficit. China’s foreign exchange reserves now total US\$610 (or roughly 40% of GDP). Some 75% to 80% of these reserves are estimated to be held in US Treasuries. China’s rate of increased reserve accumulation rose from 5% on a year-on-year basis in 2000 to some 50% by the end of 2004.

This Asian reserve accumulation accounted for some 75% of US current account financing in 2003 and over 60% in 2004 and for nearly 80% of the financing of the US fiscal deficit in these years.¹⁷ This has also arguably helped to keep long-run interest rates in the US lower than they might otherwise have been, providing even more stimulus to the US economy than the Fed’s low short-term rates. This support to the US debt market, along with the resulting downward pressure on interest rates, in turn, has reduced US savings still further, fed the housing market boom and stimulated the consumption which continues to drive US purchases of Asian exports.

Bretton Woods II

This pattern of behaviour –with the Chinese fixing their exchange rate against the dollar, and other Asian countries demonstrating a ‘fear of floating’ through the accumulation of dollar reserves, along with continued US government deficit spending, ever-growing external deficits and the maintenance of a strong consumption boom in the US– has created a symbiotic trade and financial relationship between the US and Asia which has been dubbed the new *Bretton Woods II* by a group of Deutsche Bank analysts.¹⁸ During the second half of 2004, the pros and cons of such a new Bretton Woods II scenario, its sustainability and ultimate demise, along with related consequences, have been hotly contested in what has shaped up to be one of the most central contemporary debates on the international economy.

The sustained export-led Asian boom, facilitated by relatively stable exchange rates –ie, ‘riding the dollar down’, which implies even more competitive exchange rates *vis-à-vis* the euro and the other ‘Western’ currencies as the dollar weakens– has interacted with loose US fiscal and monetary policy in the wake of the 2001 recession to generate pronounced macroeconomic imbalances at the international level. Rapid Chinese growth, driven by export expansion –obviously facilitated by a yuan which is not allowed to appreciate against the otherwise weakening dollar– has been considered essential by Chinese authorities as an engine of employment for the millions of new job seekers every year. This imperative creates the necessity to acquire dollar reserves which then need to be invested. Recycling dollars back into the US economy helps to finance US imports from the Chinese as well as to place downward pressure on long-term interest rates. Such financing –an indirect interest rate subsidy– fuels the US consumption that propels the US economy forward and underpins Asian job-creating exports to the US. Asian savings

therefore are, in the end, too high. This is expressed in the form of growing Asian trade surpluses with the US. US savings are, on the other hand, further encouraged to be too low, and this shortfall is made visible in the ‘twin’ (budget and current account) deficits, which reveal the extent to which the US has become dependent on external finance to maintain its excessive levels of consumption.

The argument underlying the position that this Bretton Woods II arrangement is both sustainable and beneficial posits that both Asians and Americans have clear interests in perpetuating this symbiotic relationship. According to this view, Asian countries, particularly China, must maintain high rates of growth to generate sufficient employment for the millions made redundant by privatisation and the millions more engaging in rural-urban migration in search of higher money wages. For China alone this means generating some 15 to 20 million new paying jobs every year. This translates into a political imperative for the Chinese regime that must strive to maintain as much social stability and consensus as possible –regardless of whether or not the true goal of the ruling Communist Party is to affect a gradual transition to market democracy–.

Furthermore, the Chinese authorities have already clearly stated –repeatedly– that they view an open and liberalised capital account, along with a free-floating exchange rate, as one of the ultimate goals of the market transition. Nevertheless, they have also clearly explained that movement towards such a goal will be gradual and carefully sequenced so as not to undermine economic and financial stability. Aside from the pressing social and political imperative to keep employment growing rapidly for years to come, the most sensitive economic issue is related to the challenging task of cleaning up and modernising the financial system and liberalising capital flows.

The Chinese financial system is indeed ill-prepared to deal with flexible exchange rate. Because interest rates are still predominantly state-controlled, there are no on-shore forward (or other currency derivatives) markets to allow exporters to hedge exposure to the unpredictable swings of flexible exchange rates. Furthermore, Standard & Poor’s estimates that well over 40% of all loans in the banking sector are non-performing. A yuan revaluation would inflate the value of these non-performing loans, while deflating the value of the US\$45bn in US treasuries which were injected into two major state banks in January 2004 as well as the other foreign reserve assets held within the Chinese banking system. Such effects, coming from the termination of the Chinese policy to hold the yuan stable against a weakening dollar, could easily unleash a wave of bankruptcies in the financial sector.

The Chinese monetary authorities have also proved to be very reticent to revalue the yuan during periods of intense appreciation speculation. To do so would possibly ignite further speculative pressures, giving way to a distorting appreciating overshoot, exacerbating the debilitating impacts on the financial system. Revaluation would also disproportionately impact the earnings of foreign-invested exporters who constitute the most dynamic economic sector and the principal growth driver.

Therefore, one would expect the Chinese authorities to continue on their present course, following their slow but steady, selective liberalisation of the capital account. So far this has included the loosening of controls on certain inflows of foreign direct investment, but not all portfolio inflows and few if any capital outflows. This leads to another interesting ambiguity in the current debates over the supposedly ‘undervalued’ yuan. A completely

liberalised capital account could easily provoke net outflows of Yuan into the dollar by mainland Chinese economic actors who are currently not allowed to purchase or invest in foreign currencies. Such a result, easily feasible, would actually produce a sharp depreciation of the Yuan against the dollar, complicating any assumptions that further currency liberalisation in China will contribute to a reduction in the trade surplus with the US. As it is, last year a number of Chinese economists estimated that between US\$30bn and US\$40bn in illegal capital flows were leaving China every year. At the very least, such considerations cast doubt on the dominant assumption that the yuan is significantly undervalued, particularly once the speculative inflows come to a halt.

For the US, such Asian behaviour, grounded in this particular perception of Asian imperatives, provides a guarantee, at least for a while, of sufficient external financing for the twin deficits, contributes to lower long-term interest rates, takes pressure off the US administration to reduce the budget deficit, allows for US savings to remain historically low and consumption to remain historically high, and for an imbalanced and vulnerable US growth pattern to be sustained. Such support to US consumption is also of extreme political utility for those running the US administration, as any form of economic slowdown, sparked by a significant dollar decline and realised through higher interest rates, or brought on by a noticeable reduction in the government budget deficit (from lower government spending, a rollback of some tax cuts, or both), would be perceived as politically dangerous for the Bush administration.

Indeed, Chinese and US leaders both have a short-term political incentive to maintain this pattern of economic and financial arrangements. With it, they might continue to enjoy the rapid growth, strong consumption and robust employment that in China may prove essential to maintaining a social consensus in favour of the market transition even while the political system remains non-democratic, and that in the US will prove very useful for the Republicans at the next midterm Congressional elections in 2006 and the next Presidential elections in 2008. Advocates of this Bretton Woods II even argue that this arrangement is a constructive mechanism by which the developing periphery (China and Asia) can interact with the developed core (the US) to successfully develop, industrialise and bring hundreds of millions out of poverty. If we assume that there are no binding constraints upon the sustainability of such an implicit arrangement –beyond the willingness of the Chinese authorities to continue to accumulate dollar assets– these advocates argue that it is likely to continue functioning effectively for a decade or more, at which time there will no longer exist a pressing political or social need to generate 15 million new wage-paying jobs a year in China.¹⁹

Nevertheless, as long as this so-called Bretton Woods II is maintained, the basic international macroeconomic imbalances upon which it is based will continue to deepen, increasing the risk of a system-threatening crisis and raising the costs of the ultimate economic adjustment that will ensue when finally this symbiotic relationship breaks down. What is more, the maintenance and magnification of such imbalances (the US current account deficit and overvalued dollar, significant accumulation of dollar reserves in Asia, particularly China, along with undervalued Asian currencies) will likely raise the economic costs that this system imposes, generate political opposition that may threaten to destabilise the Bretton Woods II arrangement long before its advocates foresee, and ultimately increase the severity of the ensuing crisis.

The Inherent Weaknesses of Bretton Woods II

There are a number of economic and political pressures inherent to this arrangement that threaten to undermine it and magnify the consequences of its demise. First, there is an imminent danger to the world's open trading system. The maintenance of the yuan peg to a dollar weakening against the other Western currencies cannot fail to contribute further to a still widening US trade deficit with China. Irrespective of the intellectual rigour of the argument, such a situation fuels the perception in the US that unfair Chinese economic practices are causing the US manufacturing base to contract and for US jobs to be eliminated and exported to, of all places, China, as more and more US firms invest or relocate abroad. If the yuan is perceived in the US to be unfairly undervalued, protectionist pressures, already significant, are bound to intensify, threatening the future of meaningful progress on regional trade accords and in the WTO-sponsored multilateral trade negotiations. Furthermore, protectionist pressures are also brewing in Europe, where the euro has appreciated upwards of 40% against the dollar and the Yuan –and significantly against the rest of Asia's currencies– since 2002, bearing the brunt of dollar adjustment in the absence of Asian appreciation. Now the euro looks set to overshoot, threatening to damage Europe's manufacturing base over the long run and dampen still further in the short run Europe's weak export-sensitive growth. Perhaps the world could survive the demise of the current Doha Development Round. Widespread resort to protectionist practices, however, to say nothing of a trade war, could easily bring Bretton Woods II to an end, provoke a dollar crisis and bring on world recession.

Already we are witnessing signs of protectionism in the US. After remaining nearly silent on the yuan's exchange rate throughout 2004, Treasury Secretary John Snow has begun to speak of it again, in the wake of the recent G7 meeting at which China was warned of the risks of not moving immediately towards a more flexible exchange rate. The US Congress has also continued to move ever closer towards defining China's exchange rate regime as illegal 'currency manipulation,' and imposing extraordinary tariff barriers on the import of Chinese products. A Senate bill is expected to be voted on by the end of July that would, if passed and confirmed into law, impose a 27.5% tariff on all Chinese goods unless the yuan is revalued within six months. Furthermore, pressures have emerged for China to engage in voluntary export restraints on textiles, particularly in the wake of the dismantling of the Multifibre agreements as of this year. It is curious that as soon as this trade distorting arrangement was finally scrapped at the insistence of the WTO, the US is now contemplating pushing China into a similar VER commitment, similar to that adopted by Japan with respect to automobiles in the 1980s. Some textile imports have increased by as much as 250% and 80% in the US and the EU, respectively, during the first quarter of 2005. China has responded by implementing an export tax on textile imports, but recently has threatened to rescind this tax if the US and Europe continue to move towards implementing new extraordinary tariffs, which they claim are legal under the WTO's safeguard provision against a 'surge' in imports. As a result, and despite the fact that the hourglass continues to run low on the Doha Round, international trade relations have not been as tense in a long time.

Second, continued reserve accumulation increases the risk that overheating will produce a hard landing for the Chinese economy and a recession in Asia, and possibly the world. Reserve accumulation feeds the tendencies –already pronounced in China– towards excessive bank lending and exacerbates inflationary pressures. Although China could potentially attempt to sterilise its currency interventions, as it has in the past, it is not clear that China will always have the necessary supply of domestic assets to drain off sufficient

liquidity to prevent excessive inflation. While it is true that inflation itself would imply a real appreciation of the yuan, and a potential correction of the bilateral surplus with the US over the long run, to choose such a strategy risks feeding, and then bursting, the many investment and property market bubbles already destabilising the Chinese economy. A hard landing would no doubt spill over into a financial crisis in China's fragile banking sector, magnifying the recessionary impact. Given that some two percentage points of the world's 5% growth in 2004 was generated by emerging Asia, an economic crisis in China would be felt the world over. While it appears that China has so far managed to avoid overheating and the hard landing fate, a sustained strategy of maintaining the yuan peg and accumulating dollars indefinitely into the future could easily upset this equilibrium in the future.

There is also the risk that the other players –who admittedly have secondary roles– in this game will begin to change their supportive behaviour under the inherent pressures of BWII.²⁰ Dollar reserve holders beyond Northeast Asia –including other Asian countries and the world's energy exporters– will begin to slow their rate of reserve accumulation or at least begin to diversify their reserves away from the dollar. Indeed, there are already signs that these processes have begun.²¹ This would place additional downward pressure on the dollar and begin to reduce the value of dollar reserves, forcing more diversification and further downward pressure. The upshot would be that Europe would begin to experience more protectionist pressures in light of an even stronger euro and China and Japan, in particular, would be faced with the necessity of accumulating even more dollars. Without the tacit collaboration of these secondary actors, it will become even more difficult and risky for the two key reserve accumulators to continue to support the dollar.

Finally, there is a growing risk that the perceived mutually beneficial Bretton Woods II arrangement –which has taken shape spontaneously as a result of 'benign neglect' of the US– transforms into a 'balance of financial terror'. This would imply the US continuing to generate the world's consumption upon an increasingly flimsy foundation of foreign debt solely to avoid the Chinese slowdown that would inevitably accompany a drop-off in US import demand. It would involve China continuing to accumulate dollar reserves and finance US deficits so as to avoid the likely slowdown that would be induced by the yuan appreciation that such a halt to reserve accumulation and US deficit financing would provoke.²² Both the US and China would be encouraged to maintain the current patterns of their economic behaviour simply to avoid provoking the economic crisis that such behaviour, at least temporarily, forestalls. This dark side of current US and Chinese policy presents the world with a particularly difficult 'exit problem'. Even if protectionism does not break out, or the Chinese economy does not overheat into its own version of an emerging market crisis, the 'balance of financial terror' could easily break down into world crisis as a result of its inherently unstable nature. The unhappy fact is that there is no easy, painless way for the main players to exit the Bretton Woods II scenario. Even more worrying, the longer this 'balance' is maintained, the more problematic the eventual exit becomes.

Potential Landings: What is at Stake? What is Necessary?

As soon as Asian official financing of US deficits ends, the long-awaited correction of the dollar is guaranteed. However, for the US external deficit to be significantly reduced, the dollar will likely need to experience another 15% to 30% real effective depreciation (implying a much greater nominal depreciation against the yuan, the yen and the other

Asian currencies). Such a steep depreciation –which could be even more severe should the dollar collapse in a speculative, panic-driven overshoot– would likely begin to feed through to domestic price inflation in the US, placing upward pressure on US interest rates. Interest rates would face further upward pressure as official and private foreign financing of US deficits dried up in the face of increasing capital losses on US assets and declining expected real returns as a result of rising inflation and collapsing growth rates which such an interest rate shock could easily produce.²³ The impact on the world economy would be magnified by the deflationary pressures in Asia implied by stronger exchange rates.

If Asia –particularly China and Japan– would naturally think twice before withdrawing official financing of the US twin deficits, the US faces similar deterrents to pursuing otherwise sensible policy designed to rein in the current account deficit, reduce consumption and increase savings –and subsequently wean the US economy of this new Bretton Woods II dependency–. All of the policy options open to the US administration that might lead to such a result (tighter monetary policy or tighter fiscal policy) imply significantly slower US growth, possibly exacerbated by a bursting of the housing market bubble and the increased burden of heavy consumer debt in a higher interest rate environment. On the other hand, because China depends to a large degree on US consumption to fuel its rapid export-led growth, any such US slowdown would reverberate through the world economy via its recessionary impact on China and eventually make US current account correction that much more difficult as world demand –already weak everywhere outside North America and Asia– slumps.

The risk of such a messy exit from Bretton Woods II to flexible rates –a destabilising breakdown of the ‘balance of financial terror’– increases the longer the exit is delayed. This, therefore, increases the importance of preparing for the exit in the meantime while the current scenario is maintained and increases the necessity of brokering a broad international agreement to manage the exit. To be sure, however, the world economy will eventually ‘exit’ from the status quo scenario. Exit via policy coordination at least has the chance to minimise the severity of the correction, while uncontrolled exit increases the likelihood of an uncontrolled and messy adjustment –a hard landing for the world– with unforeseen, if not unimaginable, consequences.²⁴

One approach would be to arrange for a new Plaza-like Agreement in which the world’s major regional economies agree to engage in the particular reforms which would produce the desired adjustment effects. Most of the commentators contemplating such a scenario would argue that the US must commit to a significant reduction of its budget deficit, that Europe engage in reforms designed to increase the flexibility of its economy and augment its capacity to increase domestic demand, particularly when it must decline in the US, and that Asia prepare for more currency flexibility. Indeed, there is at least a broad consensus among economists that this would most likely lead to the optimum global result –even if some sort of slowdown would still prove inevitable, at least for some time–.

However, such effective multilateral economic policy coordination has been historically difficult to achieve and, given the current international climate, there is no reason to believe that it would be easier now. Indeed, there are many who believe that such coordination is too utopian to consider and that the results of a failed attempt would be even more damaging than no attempt at all.²⁵

Given, then, that most of the players in this game will have to operate largely unilaterally, which economy is in the best position to act unilaterally in a way which would help achieve a more optimum exit from Bretton Woods II? In our view, this would be the US. If the Bush Administration were to unilaterally reduce the budget deficit significantly – ideally by refusing to make the previous tax cuts permanent and by scrapping its Social Security reform as currently conceived– the effect would probably be slower growth in the US which no doubt would provoke slower growth in China and the world. However, this slowdown would occur with far less upward pressure on interest rates than in the alternative scenario in which the US does nothing and a messy exit eventually causes a more severe correction in the context of higher interest rates. The difference between these two scenarios is not so much the severity of the correction which is felt in the developed world, but more the alternative effects on the emerging markets and developing economies which are much more sensitive to higher interest rates. In other words, the bulk of the adjustment caused by a messy exit from BWII will be disproportionately felt by those who always suffer more from world crisis: the vulnerable and the poor.

How will the ‘balance of financial terror’ likely play out? And how might this scenario interact with global geopolitics? These questions remain to be dealt with in a subsequent paper.

Bibliographical References

- Bernanke, Ben S. (2005), ‘The Global Saving Glut and the US Current Account Deficit’, Sandbridge Lecture, Virginia Association of Economics, Richmond, Virginia, 10 March.
- Dooley, Michael, David Folkerts-Landau and Peter Garber (2004), ‘The Revived Bretton Woods System: Alive and Well’, Deutsche Bank, December.
- Godley, Wynn A. *et al.* (2004), ‘Prospects and Policies for the US Economy: Why Net Exports Must be the Motor for US Growth’, CERF, University of Cambridge, July.
- Institute for International Monetary Affairs (2004), ‘Searching for a Stable Currency Regime in East Asia: the Role of Yuan, Dollar and Yen’, Occasional Paper 14, IIMA (Tokyo), see <http://www.iima.or.jp/pdf/2004/OP14.pdf>
- Levey, David H., and Stuart S. Brown (2005), ‘The Overstretch Myth’, *Foreign Affairs*, March-April.
- Mann, Catherine (2004), ‘Managing Exchange Rates: Achievement of Global Re-Balancing or Evidence of Global Co-Dependence?’, *Business Economics*, July.
- Mussa, Michael (2005), ‘Sustaining Global Growth while Reducing External Imbalances’, in C. Fred Bergsten, *The United States and the World Economy*, Institute for International Economics, Washington, D.C.
- Pringle, Robert, and Nick Carver (eds) (2005), *RBS Reserve Management Trends 2005*, Central Banking Publications, London.
- Roach, S. (2005), ‘The Funding of America’, Morgan Stanley Dean Witter Global Economic Forum, 23 August 2004 and 3 January 2005.
- Rogoff, Kenneth (2004), ‘Bush Throws a Party’, *Foreign Policy*, March/April.
- Roubini, Nouriel, and Brad Setser (2005), ‘Will the Bretton Woods 2 Regime Unravel Soon? The Risk of a Hard Landing in 2005-2006’, paper written for the Symposium on the ‘Revived Bretton Woods System: A New Paradigm for Asian Development?’, Federal Reserve Bank of San Francisco and UC Berkeley, 4 February (see Roubini Global Macro Web Site at <http://www.stern.nyu.edu/globalmacro/>)

- Rubin, Robert E., Peter R. Orszag and Allen Sinai (2004), *Sustained Budget Deficits: Longer-Run U.S. Economic Performance and the Risk of Financial and Fiscal Disarray*, Brookings Institution, January.
- Steinberg Wechsler, Federico (2005), 'Interdependencia financiera global: equilibrios múltiples en Bretton Woods II', unpublished paper presented at the VII Reunión de Economía Mundial, Complutense University, Madrid, April.
- Summers, Lawrence H. (2004a), 'The U.S. Current Account Deficit and the Global Economy', *The Per Jacobsson Lecture*, The Per Jacobsson Foundation, Washington, D.C., 3 October.
- Summers, Lawrence H. (2004b), 'The United States and the Global Adjustment Process', *Third Annual Stavros S. Niarchos Lecture*, Institute for International Economics, Washington, D.C., 23 March.
- Williamson, John (2004), 'The Choice of Exchange Rate Regime: The Relevance of International Experience to China's Decision', Conference lecture at the Central University of Finance and Economics, Beijing, 7 September, see <http://www.iie.com/publications/papers/williamson0904.pdf>
- Wolf, Martin (2004a), 'America is Now on the Comfortable Path to Ruin', *Financial Times*, 18 August.
- Wolf, Martin (2004b), 'Why the US Current Account Deficit is a Cause for Concern', *Financial Times*, 25 August.

¹ See, for example, Michael Mussa, 'Sustaining Global Growth while Reducing External Imbalances,' p. 180, in Fred C. Bergsten and the Institute for International Economics, *The United States and the World Economy: Foreign Economic Policy for the Next Decade*, Washington: IIE, January 2005. However, those from the 'twin deficit' school might argue that while the current account and fiscal deficits are not necessarily 'identical' twins, they are perhaps 'non-identical' twins, or at the very least, siblings, in that they can have direct and indirect feedback effects upon each other. While external and internal deficits might not always move in the same direction in the short run, they become particularly dangerous when they 'appear' as twins, that is when both are simultaneously large and growing, and when they begin to act as twins.

² See, for example, Ben S. Bernanke, member of the Board of Governors of the US Federal Reserve, 'The Global Saving Glut and the US Current Account Deficit', Sandbridge Lecture, Virginia Association of Economics, Richmond, Virginia, 10 March 2005.

³ See Michael Mussa, *op cit*.

⁴ Since the dollar's 'twin peaks' against the euro in late 2000 and early 2002, the euro has appreciated against the dollar in nominal terms by approximately 40%. The Anglo-Saxon currencies (the Canadian and Australian dollars, along with Sterling) have appreciated against the dollar by more than 20%. The Japanese yen has appreciated more than 10% but in real terms there has been no movement.

⁵ The typical delay in current account correction after an exchange rate movement (known as the J-curve effect) takes anywhere from six months (according to Nouriel Roubini) to two years (according to Michael Mussa) to occur. Even according to the view which expects a two-year delay, the US current account deficit should now be improving significantly, given that the bulk of the real exchange rate depreciation to date has occurred during 2002, 2003 and 2004. Either there are other factors (ie, oil price increases) preventing the J-curve from executing an improvement, even if delayed, in the US current account, or the necessary 'expenditure adjustment' – crucial as a complement to the 'expenditure switching' caused by currency depreciation – has simply not taken place due to continued increases in the US budget deficit and US household indebtedness levels.

⁶ According to the most recent monthly data, the trade deficit figure fell by US\$5.6bn to US\$55bn in March. See the Bureau of Economic Analysis, <http://www.bea.doc.gov/bea/newsrel/tradnewsrelease.htm>. However, such a level still puts the trade deficit at US\$660bn on an annualised basis, an increase of nearly 8% over 2004.

⁷ The most recent figures for the US NIIP date from year-end 2003, and put it at US\$2,430bn. See http://www.bea.doc.gov/bea/newsrelarchive/2004/intinv03_fax.pdf. However, factoring in the current account deficit from 2004 and the first quarter of 2005 would likely put it above US\$3,000bn.

⁸ See, for example, Nouriel Roubini and Brad Setser, 'Will the Bretton Woods 2 Regime Unravel Soon? The Risk of a Hard Landing in 2005-2006'. Nevertheless, there are others, like Michael Mussa, who argue that an NIIP of 50%-60% –as opposed to one of 100% of GDP– would not constitute a real danger, while still others, like Helene Rey, argue that automatic adjustment mechanisms inherent within the financial account and NIIP, acting through dollar depreciation effects on US-held foreign assets, will push out the ultimate limits that US external deficits face in the future to far beyond what many fear today are imminent constraints. Such perspectives will be dealt with below.

⁹ Although Lawson did see a growing danger in the US, where the large and growing current account deficit was accompanied, and fed, by its 'twin', the large and growing public sector deficit. The dollar collapse of 1987, and the subsequent stock market crash of October 1987, seemed to vindicate the distinctions made in the Lawson Doctrine.

¹⁰ According to Michael Mussa, while the actual fiscal position in the US shifted by some 6 percentage points of GDP between 2000 and the end of 2004, the structural deterioration in the US fiscal position over the same period was equivalent to 4% of GDP.

¹¹ Robert E. Rubin, Peter R. Orszag and Allen Sinai, *Sustained Budget Deficits: Longer-Run U.S. Economic Performance and the Risk of Financial and Fiscal Disarray*, Brookings Institution, January 2004; Lawrence H. Summers, 'The United States and the Global Adjustment Process', IIE, March 2004; Lawrence H. Summers, 'The U.S. Current Account Deficit and the Global Economy', Per Jacobsson Lecture, September 2004; Kenneth Rogoff, 'Bush Throws a Party', *Foreign Policy*, March/April 2004; Wynn A. Godley, *et al.*, 'Prospects and Policies for the US Economy: Why Net Exports Must be the Motor for US Growth', CERF, University of Cambridge, July 2004; Stephen Roach, 'The Funding of America', Morgan Stanley Dean Witter Global Economic Forum, 23 August 2004 and 3 January 2005; Martin Wolf, 'America is Now on the Comfortable Path to Ruin', *Financial Times*, 18 August 2004, and 'Why the US Current Account Deficit is a Cause for Concern', *Financial Times*, 25 August 2004; and Catherine Mann, 'Managing Exchange Rates: Achievement of Global Re-Balancing or Evidence of Global Co-Dependence?', *Business Economics*, July 2004.

¹² International Monetary Fund, *World Economic Outlook*, Washington, D.C., April 2004 and April 2005.

¹³ Alan Greenspan, Chairman of the Federal Reserve Board, 'Current Account', remarks at the Advancing Enterprise 2005 Conference, London, 4 February 2005; Ben S. Bernanke, Member of the Board of Governors of the US Federal Reserve System, 'The Global Saving Glut and the US Current Account Deficit', remarks at the Sandridge Lecture, Virginia Association of Economics, Richmond, Virginia, 10 March 2005; and Roger W. Ferguson, Jr., Vice-Chairman of the Board of Governors of the US Federal Reserve System, 'US Current Account Deficit – Causes and Consequences', remarks to the Economics Club of the University of North Carolina at Chapel Hill, North Carolina, 20 April 2005.

¹⁴ Indeed, as of late this trend has been reversed as the dollar has strengthened against many Western currencies, particularly the euro. The Fed's defence of the sustainability of US external deficits and its insistence on their benign nature seems to have calmed the markets in recent weeks, allowing investor attention to return to more short-term, cyclical factors affecting the dollar-euro exchange rate (like the widening growth and interest rate differentials between the US and the Euro zone, and issues of market sentiment, like the impact of the victory of the No vote in the recent referendum on the EU constitution). As a result, the euro has recently slid to as low as US\$1.23/€ However, this makes the remaining current account adjustment that still must take place *vis-a-vis* the Euro zone all the more difficult for the US.

¹⁵ These Fed representatives make surprisingly little direct reference to the effect that US monetary expansion might have had on the current account deficit.

¹⁶ See Wolfgang Munchau, 'The Dollar has Fallen Enough', *Financial Times*, 20 March 2005, citing Pierre-Olivier Gourinchas and Hélène Rey, 'International Financial Adjustment', CEPR Discussion Paper, 4923. See also David H. Levey and Stuart S. Brown, 'The Overstretch Myth', *Foreign Affairs*, March/April 2005.

¹⁷ See Nouriel Roubini and Brad Setser, 'Will the Bretton Woods 2 Regime Unravel Soon? The Risk of a Hard Landing in 2005-2006', and Nouriel Roubini's Global Economics Blog, 'Is the US Really Serious about Demanding a Revaluation of the Chinese Currency', 17 April 2005, at www.roubiniglobal.com.

¹⁸ See Michael Dooley, David Folkerts-Landau and Peter Garber, see 'The Revived Bretton Woods System: Alive and Well', December 2004.

¹⁹ Originally, Garber, Dooley and Folkerts-Landau argued that this new informal system of fixed exchange rates could be sustained for a generation –until China's agricultural labour surplus was absorbed in a new urban industrial sector–. More recently, Garber has suggested that while it will not last forever, it should be sustainable until around 2012.

²⁰ Indeed, we must remember the current Bretton Woods II arrangement is a purely informal arrangement, a pattern of global economic behaviour that has evolved in an uncoordinated fashion and implies no formal mutual commitments.

²¹ See Robert Pringle and Nick Carver (eds), *RBS Reserve Management Trends 2005*, Central Banking Publications, London, 2005.

²² The term ‘balance of financial terror’ was first used in this context by Lawrence H. Summers, the President of Harvard University and former Secretary of the Treasury in the Third Annual Stavros S. Niarchos Lecture (‘The United States and the Global Adjustment Process’) at the Institute for International Economics, Washington, D.C., 23 March 2004.

²³ A range of estimates have been produced as to the impact on US interest rates should Asian central bank financing of US deficits terminate. The highest estimate is that of Nouriel Roubini and Brad Setser, who see US rates rising by at least 200 basis points as a result. See Roubini and Setser, *op. cit.*

²⁴ For a discussion of the possible multiple equilibria that an eventual exit from BWII would imply, see Federico Steinberg, ‘Interdependencia financiera global: equilibrios múltiples en Bretton Woods II’, unpublished paper presented at the VII Reunión de Economía Mundial, Complutense University, Madrid, April 2005.

²⁵ See Samuel Brittan, ‘A Heretical View on the Dollar’, *Financial Times*, 20 January 2005.