

The Economists' Voice

Volume 1, Issue 3

2004

Article 2

The Unsustainability of U.S. Trade Deficits

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Summary

Although substantial current account deficits can be sustained indefinitely, large deficits in goods and services trade cannot be. Even to stabilise the current account deficit, the United States must restore balance in goods and services trade within a decade or so. If this adjustment is to be achieved without a crisis, a range of policy adjustments will be needed. Options include a managed devaluation of the US dollar, substantial increases in public and household saving and initiatives to reduce reliance on imported oil and gas.

KEYWORDS: current account, trade deficit, unsustainability, financial crisis, soft landing

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Erratum

In paragraph 2, page 7, the text should read “the appreciation of the yen” instead of “the depreciation of the yen”.

*If something cannot be sustained forever, it will stop.
Herbert Stein.*

Stein's aphorism is usefully applied to the U.S. balance of trade in goods and services. In the three months to August 2004, the monthly trade deficit in goods and services averaged \$53 billion — around six percent of gross domestic product (GDP). This means that \$53 billion more goods and services were imported by the United States than were exported. The goods and services deficit has grown steadily since the 1990s (Figure 1). Sustained large deficits in goods and services trade eventually imply unbounded growth in indebtedness, and exploding current account deficits.¹ Lenders are not willing to support unbounded growth in debt relative to GDP, because eventually interest due would exceed GDP. The deficits will stop growing. But when, and how?

The growing trade deficit has received relatively little attention in public debate. Even within the economics profession, discussion of the sustainability of the U.S. trade deficit has been muted. This apparent lack of interest has several possible explanations:

First, as Stein says, an unsustainable deficit won't last. Some adjustment process will restore balance. But adjustment may not be pleasant.

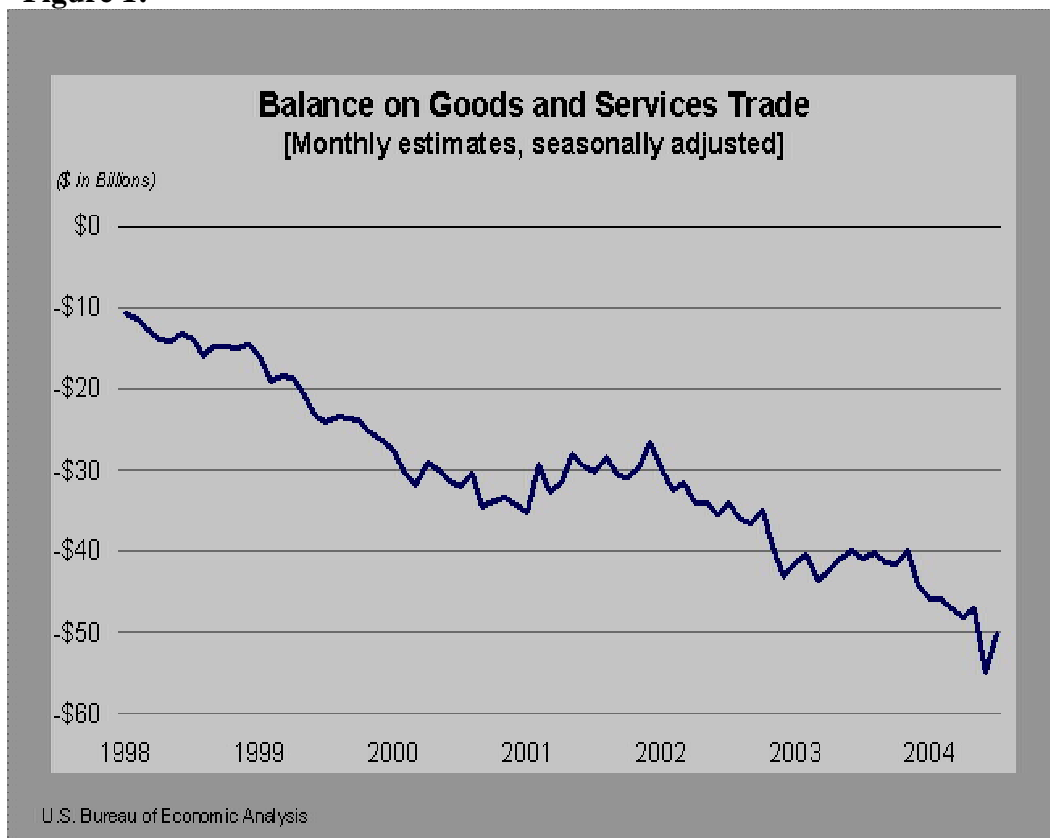
Second, much analysis confuses the current account deficit and the goods and services deficit. In the U.S. today the current account deficit is roughly equal to the goods and services deficit at five to six percent of GDP. A number of countries — notably Australia and New Zealand — have run current account deficits of this magnitude for years, reflecting net foreign obligations around 60 percent of GDP. This has led some commentators to suppose that the present U.S. position can be sustained indefinitely. But as time passes and income payments owed to foreigners mount, the current account deficit will become larger than the goods and services deficit. In order to have a stable current account deficit, a country must run a goods and services surplus to keep its net foreign debt from growing faster than GDP.²

¹ The balance of trade is composed of payments for good and services — the goods-and-services deficit. The balance of payments on current account is the balance of trade plus net income payments, most of which takes the form of interest on debt or profits earned by foreign-owned assets. The balance of payments on current account is equal and opposite to the balance on capital account, which is the net amount borrowed from, or invested by, foreigners.

² This assumes that the average rate of return on foreign-owned assets is greater than the rate of growth of GDP, as is normally the case.

The Australian experience illustrates this point: Australia had consistent goods and services deficits of two percent of GDP or so from 1960 to 1990. The ratio of net foreign claims to GDP grew to 80 percent of GDP by 1990. During the 1990s, Australia generally ran a small surplus on the goods and services account (about 0.5 percent of GDP) and the current account deficit stabilized at around five percent of GDP. A substantial current account deficit can continue indefinitely. A substantial goods and services deficit cannot, because it generates an exploding current account deficit. (Australia is illustrative in another important respect. On the way to stabilizing the current account deficit, the Australian economy went through a severe recession, largely driven by contractionary monetary policies, including interest rates of up to 17 percent)

Figure 1:



A third reason for complacency is the belief that central banks in Asia and Europe will keep on buying U.S. dollars indefinitely, and that the United States

therefore faces no effective constraint on borrowing. This arrangement has been referred to, by Dooley, Folkerts-Landau and Garber (2003), and by others, as a “revived Bretton Woods system.” But in any situation where a seller extends credit to a buyer, there comes a point when the risk of being left with steadily depreciating or uncollectible debts exceeds any benefits from being able to export goods. Geopolitical objections are even more serious. The Chinese central bank will soon hold the better part of a trillion dollars in U.S. government bonds. Even minor unpleasantness in foreign policy would create strong pressure for the Bank of China to diversify some of its existing holdings into yen and euros. To avoid a resulting dollar crash, it would be necessary to mollify the Chinese government. Could this be an acceptable situation for the United States?

Fourth, there are various private sector versions of the “new Bretton Woods” argument based on the idea that foreigners will be willing to hold U.S. assets indefinitely—even when such assets yield negative returns. This idea is associated with the ‘consenting adults’ view of the current account deficit which says that the capital account balance (equal and opposite to the current account) is simply the aggregate of borrowing and lending transactions between individuals and firms located in the United States and overseas. If these individuals and firms are supposed to be rational, there should be no reason for macroeconomic policy to be concerned with the capital and current accounts.

There are arguments for and against the ‘consenting adults’ hypothesis. However, it has become increasingly irrelevant. During 2003 and 2004, private investors have ceased accumulating U.S. government debt and have reduced investments in U.S. enterprises. It is only government intervention by foreign governments buying U.S. debt that is now maintaining the value of the U.S. dollar.

A Soft Landing?

Trade deficits cannot go on forever. The U.S. current account deficit must be stabilized relative to GDP, and this means that the goods and services account must sooner or later return to balance or surplus. But what will the adjustment process look like?

A simple spreadsheet model is enough to get a fairly accurate picture. Suppose that the U.S. trade deficit on goods and services levels out at five percent of GDP, stays at that level until 2007, and then over the next decade returns to sustainability through a gradual non-crisis adjustment. Assume that the goods and

services deficit declines steadily over the following decade, stabilizing at a surplus of 1.5 percent of GDP from 2015 on. Over this period, net external obligations increase steadily, and so do the associated income payments. The equilibrium position has net foreign obligations equal to around 80 percent of GDP (about \$9 trillion at the current level of GDP), and a stable current account deficit at five percent of GDP.

The required adjustment along such a path turns out to be quite rapid. To move from a deficit equal to five percent of GDP to a surplus of 1.5 percent over eight years, the adjustment path requires the goods and services deficit to be reduced at an average rate of 0.8 percentage points of GDP (about \$90 billion at the current level of GDP) per year: every year after 2007 the United States must switch 0.8 percent of GDP's worth of spending away from net imports.

Currently the United States imports about half as much again as it exports. Without radical changes in the U.S. economy, or specific policy initiatives on energy, a large deficit on oil imports can be taken as a given. There are important classes of consumer goods for which domestic production has ceased. If balance is to be reached in a decade, there has to be a major turnaround in the pattern of trade in some other sector. But what? At the moment, there is no sector in which the United States is currently running a significant surplus (there is a small surplus on services, but even here, the trend is flat or negative). Even with the recent depreciation of the U.S. dollar, and widely-noted productivity growth, there are no signs that U.S. producers are gaining market share in any part of the traded goods sector.

Any significant reduction in the imbalance on goods and services therefore appears likely to require very large changes in market prices or U.S. income levels, such as:

- A (further) larger devaluation of the U.S. dollar.
- Large reductions in U.S. wages relative to those overseas.
- Large increases in U.S. productivity relative to foreign productivity (the relevant concept here is multi-factor productivity, taking account of both capital and labor inputs).
- Large reductions in U.S. consumption relative to foreign consumption.

Unfortunately, no one of these alone would be enough to get the trade deficit in balance or surplus without a crisis. For example, to get to balance by devaluation alone would require a devaluation of the order of 50 percent, which would certainly entail both an upsurge in inflation and an increase in interest

rates. A lot of emphasis is (rightly) put on productivity, but even on the most optimistic accounts the gap in annual productivity growth rates between the United States and other countries is no more than one percentage point, which cannot produce a substantial effective shift in the terms of trade in the short term.

To get back to balance via an increase in national savings requires shifts of a similar magnitude. At the moment, roughly 40 percent of each marginal consumption dollar in the United States is currently allocated to imports, so the restoration of balance through increased household saving alone would require an increase in national saving equal to something like 12 percent of GDP. As such an individual saving increase is unlikely, a return to substantial government surpluses would be needed.

Those looking forward to a gradual adjustment process and a soft landing for America's goods and services deficit are implicitly looking forward to very large but nevertheless gradual changes in relative prices and expenditure shares.

Why Does the Dollar Remain High and U.S. Interest Rates Continue to Be Low?

Given that a substantial devaluation of the U.S. dollar against Asian currencies and a further devaluation against the euro appears an inescapable part of the adjustment necessary to eliminate the U.S. goods and services deficit, it is natural to ask why this has not been reflected in market outcomes—particularly in interest rates. As of October 2004 the market interest rate on ten-year Treasury bonds was four percent, almost exactly equal to the movement in the CPI for the first eight months of 2004³. So investors are taking a zero real return on an asset with a high probability of yielding a substantial capital loss. The phenomenon is inconsistent with the idea that fully rational investors maximize their long-run expected returns, but it seems undeniable.

One possible explanation would begin with the observation that many investors hold fairly stable shares of their wealth in different currencies, and tend not to adjust these shares even when currencies appear to be substantially misvalued. In the presence of substantial government intervention to stabilize an overvalued exchange rate, such investors might respond by shortening the maturity of the assets they hold in the overvalued currency, so that they would be

³ The U.S. Federal Reserve prefers to focus on a 'core' inflation measure that excludes food and energy prices and is currently at a rate of about two percent per year. Even using this measure, the real interest rate is low.

in a position to liquidate their holdings before the severe depreciation took place. This may already be happening.

But such a shift in demand to short-term assets ought to produce a steeper yield curve, with long-term assets paying much higher interest rates than short-term ones. This has not been visible, perhaps because it has been offset by changes in the U.S. Treasury's funding patterns: In 2001 the U.S. Treasury ceased issuing 30-year bonds, and the value of all Treasuries with maturities of ten years or more is now only \$550 billion.

For the time being, the willingness of Asian central banks to incur losses in order to support the dollar, and the determination of U.S. monetary authorities to maintain low short-term interest rates, have maintained an equilibrium in which the U.S.-dollar denominated securities can trade at low interest rates, despite the inevitability of a devaluation. However, it would be unwise to suppose that this pattern can be sustained for much longer.

An Orderly Adjustment Path

An orderly adjustment might still be possible. The obvious model for this adjustment is the Plaza Accord of the mid-1980s, and the associated winding back of U.S. budget deficits, which resolved the first major current account crisis experienced by the United States.

Until the late 1970s, the United States had generally run modest surpluses on both the trade and current accounts, but, with an appreciation of the U.S. dollar, deficits grew rapidly from 1980 onwards, reaching about 2.5 percent of GDP in 1985. Finance ministers and central bankers from the world's five leading economies (France, Germany, Japan, the United Kingdom, the United States), met at the Plaza Hotel in New York, and announced that the exchange value of the dollar was too high and that the nations would coordinate their intervention actions in order to drive down the value of the dollar.

The result was a 40 percent devaluation of the U.S. dollar against the currencies of major trading partners. Over the same period, the U.S. budget deficit, which had been greatly increased by the tax cuts introduced by Ronald Reagan in 1981, was wound back by a combination of tax increases and expenditure cuts, falling from six percent of GDP in 1983 to three percent in 1989.

These measures were successful in their immediate goal. After peaking at about 3.5 percent of GDP in 1987, the trade and current account deficits fell steadily until the early 1990s, ranging between one and two percent of GDP in this period.

The effects of the Plaza Accord were not entirely beneficial. Many economists have argued that the depreciation of the yen contributed to the Japanese asset price bubble, which burst spectacularly in the early 1990s. However, it seems that inadequacies in domestic financial policy were at least as much to blame as currency movements.

The starting point for policy in 2004 is considerably less favorable than in 1985. The trade deficit is nearly twice as large, relative to GDP, and the United States is already a substantial net debtor, whereas in 1985 it was a net creditor. This suggests that the currency and budget adjustments will need to be at least as vigorous as in the 1980s and that, even with substantial adjustments, more specific interventions may be needed.

In relation to exchange rates, the U.S. dollar has already depreciated significantly against the yen and euro, but much more depreciation is needed. In addition, it is necessary that the Chinese currency should appreciate against the dollar in real terms. The preferable route would be through a managed appreciation. If this does not occur, the same real effect may be produced through an acceleration in inflation, which is already evident.

In budgetary policy, the task of the next Administration is both to reduce short term deficits and to produce a coherent plan to address the long term problems of Medicaid and Social Security, thereby making U.S. assets more attractive to long term investors.

The most obvious area for specific intervention is in relation to energy. The U.S. is a large importer of oil and gas, primarily because U.S. energy consumption per person is much higher than in other developed countries. The obvious way to address this would be through measures to raise taxes to levels comparable with those in other countries. However, if, as seems likely, such a policy is politically impossible, measures to encourage energy conservation, such as a tightening of fuel economy standards for automobiles, might be a second-best alternative.

Adjustment by Crisis

In the absence of a smooth adjustment, there are various ways in which the unsustainable trend in the deficit could be reversed rapidly. Though the details vary, none are pleasant and all have the same main outcome, that is, a currency crisis with an associated recession.

One possibility is that central banks could decide to stop accumulating U.S. dollar assets. Some smaller Asian countries, such as Singapore and Taiwan have large reserves and are therefore heavily exposed to the risk of a depreciation in the dollar. Given reserve holdings at the end of 2003, a ten percent appreciation of the Singapore dollar against the U.S. dollar would result in a domestic currency capital loss of around ten percent of GDP (Higgins and Klitgaard 2004). A decision by heavily-exposed countries to reduce U.S. dollar reserves could have a cascading effect, producing a devaluation, and forcing others to follow suit.

A second possibility is that of a speculative attack, similar to that which destroyed the European Exchange Rate Mechanism in 1993. In a situation where a price adjustment is inevitable, but is being resisted by a government or central bank, speculators may short-sell the asset on a large scale, perhaps using derivatives to amplify the impact of their transactions, in the expectation that the costs of resistance will become too great to bear. An obvious candidate for speculative attack is the pegged value of the Chinese renminbin yuan. Speculators could sell assets denominated in U.S. dollars and buy assets in yuan. The poorly-developed state of Chinese financial markets would render such an attack very risky, but also potentially highly profitable.

Even in the absence of any obvious trigger, a gradual loss of confidence in the U.S. dollar could be reflected in depreciating exchange rates and rising market interest rates over a period of months or years. Such an adjustment would be slow in relation to the timescales on which financial markets operate, but rapid in relation to the capacity of the real economy to respond.

However it takes place, the consequences of a rapid loss of confidence will follow a pattern familiar from a broad range of recent financial crises in countries including Mexico, Thailand and Argentina. Interest rates will increase, and access to credit will be reduced. Heavily indebted households and businesses will face severe distress⁴ and will be forced to reduce consumption and

⁴ Households with fixed-rate mortgages will be insulated from the effects of rising interest rates, though they may suffer from a decline in house values. In addition, unless the mortgage is assignable, the possession of a mortgage fixed at rates below current market levels makes it costly

employment, or perhaps face bankruptcy or liquidation. These processes will reduce aggregate consumption, and therefore the demand for imports. In this way, the trade account will be returned to balance, but with a sharp reduction in aggregate activity and a corresponding increase in unemployment and business failure.

Concluding Comments

It is inevitable that the U.S. trade account will return to balance, and likely that most of this adjustment will take place within the next ten years. The only question for policy is whether the adjustment will be relatively smooth, like the process which resolved the first U.S. trade deficit blowout in the 1980s, or sharp and costly, as in the case of the many countries that experienced financial crises in the 1990s.

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