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Why Deficits

BY MENZIE CHINN AND BENN STEIL

Chinese president Hu Jintao's recent visit to America provided ample grist for the media mills, but despite all the attention surrounding protocol gaffes the real story of the meetings was lack of progress along any policy front, including economic relations. In spite of Washington's chiding and threats over the growing trade imbalance, Beijing knows it has Treasury by the bonds. Roughly a third of China's central bank reserves, approaching an astounding \$1 trillion, are in U.S. Treasury notes.

The question is therefore when the Administration and Congress will finally face up to the fact that America's deficits are American problems requiring American

action. The current account deficit is now running at record heights of \$805 billion, 6.4 percent of GDP, requiring about \$2 billion of imported capital each day to sustain. Fueling the current account deficit is the Federal budget deficit, which, while down from 3.6 percent of GDP in 2004 to 2.6 percent in 2005 after a year of exceptional tax receipts, is set to soar anew on the backs of hurricane and war costs, runaway entitlement spending, and Washington's revealed preference for foreign borrowing over cutting pork and raising revenues at home. The recent \$39 billion in projected spending cuts adopted by Congress for programs such as Medicare and student loans amounted to great dramatic theater, but a mere seven one-hundredths of 1 percent of GDP.

The Administration's response to the so-called "twin deficits" has been a yawn.

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And why the coming soft dollar policy is no solution to America's huge imbalances.

Matter

In accordance with the vice president's neoeconomic postulate that "deficits don't matter," there is no policy beyond sending out the U.S. Treasury secretary at the bottom of a news cycle to cajole the Chinese into allowing greater currency "flexibility," which the whole world had feted them for *not* doing during the Asia crisis. These are therefore merely thinly veiled calls for a weaker dollar, no different from the devaluation cries heard routinely around the world from export interests.

But outsourcing deficit management to the currency market is junk economics and irresponsible geopolitics. Even if China revalues by the large levels demanded in such proposals as the Schumer-Graham bill, the yawning American trade gap will remain. Recent econometric analysis of the trade and currency data show the responsiveness of U.S. imports to movements in the dollar to be vastly lower than politicians assume. Thus, particularly because imports currently exceed exports by such a large amount, the higher dollar price of imported goods will make the trade deficit *larger*, at least until exports start growing rapidly. And that may take a very long while.

Furthermore, readjustments of relative prices via exchange rates won't bring much pro-

duction back onshore. Textile factories that have closed over the past decade won't reopen even after a steep dollar decline. A significant Chinese revaluation will lead to higher imported sock prices at Wal-Mart, not a sprouting of new American sock plants.



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Savings Glut Hypothesis

The anointment of Ben Bernanke as Federal Reserve chairman will, unfortunately, actually reduce pressure on the Administration and Congress to move beyond the soft dollar campaign. The *Economic Report of the President*, released in February 2006, clearly bore the imprint of Bernanke's rosy view of cause and effect in the American current and capital accounts. In Chapter 6, entitled "The Capital Account Surplus," President Bush's advisers sought to paint the current account deficit as a consequence of foreign investors voting enthusiastically on investment opportunities in the United States.

This claim ignores the fact that a substantial portion of this capital inflow originates from central banks and other quasi-governmental institutions, not from private investors. As former Council of Economic Advisers Chairman Martin Feldstein has pointed out, the oft-reported 17 percent share for official inflows includes only those transactions directly attributable to central banks and other monetary authorities. It does not capture

transactions undertaken by private banks on behalf of central banks, nor does it include purchases of U.S. Treasuries made by state-owned enterprises. Using the conservative assumption of an extra \$150 billion of inflows attributable to unreported transactions by central banks, roughly 30 percent of inflows are coming from the official sector. At this level, the "global savings glut" hypothesis becomes much less compelling, yet this mantra has become another justification for inaction in Washington.

—M. Chinn and B. Steil

The Fed's Bernanke: his global savings glut hypothesis justifies inaction in Washington.



America's comparative advantage vis-à-vis China is clearly in high-technology goods, particularly those with potential military applications. Yet these are precisely the goods the Administration is determined to keep out of Chinese hands, even in the face of European delight at the prospect of cashing in

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as Beijing continues its prodigious military build-up without American suppliers. It is difficult to envision, therefore, what precisely would stoke the sort of surge in U.S. exports to China that could make a serious dent in the ballooning trade gap.

The second flaw in a soft dollar policy is the naïve belief that a dollar decline will be orderly and painless. This is what the Administration is banking on, but its own policies are guaranteed to undermine it. As U.S. policymakers continue to push forward with unbridled spending and tax cut plans that raise the trajectory of future budget deficits, foreign investors are certain at some point to turn their backs on the ever-expanding stock of U.S. Treasuries, and turn instead to investments in other countries' assets. Central banks, such as Sweden's Riksbank, are already known to be doing this with their reserves.

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When the extraordinary level of official financial flows to the United States does dry up, American policymakers will be confronted with some very unpleasant choices. Especially if oil prices, now past \$70 a barrel, continue to rise, the trade deficit will become even more insensitive to changes in the dol-

lar's value. As a result, the dollar may have to fall by commensurately still *larger* amounts to shrink the trade deficit. The Fed will try to forestall a dollar plunge with growth-crunching hikes in interest rates. This will slow the dollar's slide, but not stop it.

Consider what a bad scenario for the dollar will actually look like. There is a discomfiting contrast to be drawn between the economy today and in 1985, when many were already proclaiming the U.S. current account deficit "unsustainable." Twenty years ago, when the U.S. current account deficit stood at 2.8 percent of GDP, foreign governments owned 8.4 percent of U.S. government debt outstanding. At the end of 2004, with the current account deficit at 5.2 percent of GDP, foreign governments owned a much higher 27.6 percent of the total debt outstanding. This is a cause for concern, as it represents a much greater concentration of holdings among a group that is prone to herding.

Central banks around the world hold roughly two-thirds of their reserves in dollars. Asian central banks alone have amassed an astonishing \$2 trillion in reserves, most of it in dollar assets. As the dollar has shed nearly a third of its value against the euro

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just since 2002, prudence would suggest a reevaluation of the relative weight of dollar holdings in official portfolios going forward. Indeed, strong hints that a reweighting was underway were clear in late 2004 and early 2005, with reports of dollar sales by the Chinese and Russian central banks, said to be

for euro and Asian currencies, and strong hints from Japan, Korea, and India that future Treasury purchases would be curtailed.

The dollar has since been bailed out by a heady combination of EU constitutional chaos and French and German political angst, on the one hand, and petrodollar parking in U.S. assets on the other. Resurgent gold, recently at a quarter-century high of over \$700 an ounce, was the main haven for dollar bears in 2005, but with the eurozone set to expand by a dozen or more nations in as many years going forward, it is clear that the still-fledgling euro's international allure has enormous upside potential.

Now consider the fact that precedent is not encouraging for the dollar. Witness the fate of gold as a central bank reserve holding in the 1980s and 1990s. Over the course of the 1980s, when the gold price fell from \$615 to \$381 an ounce, central banks added a net 344 tons of gold to their reserves. Yet over the 1990s, as gold fell further to \$279 an ounce, central banks sold a net 3,148 tons. In one year alone, 1992, central bank sales amounted to nearly a quarter of the annual gold supply, depressing the price by an estimated 8.27 percent. Central bank net gold sales continued at annual rate of 500 tons in the early years of this decade.

The dollar has since fully supplanted gold as the foundation of the world's monetary system; a feat unprecedented in world history for a completely uncollateralized fiat currency. But should the dollar continue an extended decline, under pressure from unprecedentedly high trade deficits, there is every reason to believe that central banks will seek greater diversification in their reserves, most likely into euros.

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As central banks bailed out of gold in the 1990s, their herding out of dollars will accelerate the dollar's decline.

If the Bush Administration persists in projecting an image of insouciance over the dollar's long-term fate, this will undermine the currency's hard-earned role as the world's pre-eminent standard of value. It will also reduce America's influence over the setting of global norms in international commerce. Such a decline would halt the further march of dollarization in Latin America (where Ecuador and El Salvador recently ditched their currencies, and with them the very possibility of capital account crises): a march that is every bit in America's long-term economic and security interests.

So, what should be done? The beginning of wisdom is to acknowledge that a more flexible or even significantly revalued Chinese currency will not be the savior of the U.S. trade deficit. But the fact that both the Administration and Congress continue to bank on this false hope prevents the nation from pursuing more difficult but far more reliable solutions.

First among these measures—and the one meaningful action the Administration and Congress can undertake in short order—is to forge a serious and workable plan to reduce the federal budget deficit over the next five years, and the trajectory of future deficits going further forward. This, of course, is easier said



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The Smoot-Hawley Tariff Act of 1930 raised U.S. tariffs on over 20,000 imported goods to historically high levels. The act was championed by Senator Reed Smoot, a Republican from Utah, and Representative Willis C. Hawley, a Republican from Oregon. President Herbert Hoover had asked Congress for a limited upward revision of tariff rates on farm products and adjustment of a few industrial rates, but once the tariff revision process was started, requests from industrial sector special interest groups poured in.

than done. Political forces arrayed against spending cuts and tax increases remain very strong.

The impact of budget cuts on the trade deficit is difficult to measure precisely—studies find that every \$100 in budget deficit reduction yields from \$20 to \$50 in trade deficit reduction. Yet budget deficit reduction is the only lever available to cut America's dependence on imported capital that is both economically sensible *and* under the U.S. government's direct control. Many commentators have pointed to America's low and declining private savings rate as an important target, but decades of government tax incentives to boost private savings have yielded little more than windfalls to those wealthy enough to be able to shuffle their existing savings toward whatever tax carrots are dangled before them.

Broad-scale protectionism as an answer is so demonstrably self-defeating that it must be resisted through vigorous public diplomacy. Schumer-Graham tariffs of 27.5 percent on Chinese goods would become this century's Smoot-Hawley disaster. The trade deficit is ultimately determined by national saving and investment: protectionism does not increase production and, absent an outright banning of trade, does not even affect the trade balance. With China feverishly pursuing new bilateral trade agreements around the globe, America can ill-afford this shortsighted domestic political pacifier. America must, to the contrary, seek to bolster the multilateral trading system, which is the country's only effective bulwark against contagious global protectionism in times of political stress.

The Administration can continue to look for help from abroad by pressing Western Europe and Japan ever more firmly to boost their growth rates. Better growth among America's richest trading partners will fuel U.S. exports and bring down the trade deficit. But the Europeans will be slow or worse to eliminate dis-

incentives to work and job creation, and the Japanese will remain disinclined to consume as long as they continue to doubt their government's ability and commitment to carry on providing for the retired while creating opportunity for the young. Thus the policy burden is necessarily on America to reverse its growing fiscal imbalance.

A painful period of world economic adjustment appears inevitable without firm and immediate action on the budget deficit, and it will have serious implications for America's power in the world. A plunging dollar accompanied by rapidly rising interest rates and a weakening American economy will make other nations less deferential to American wishes at the International Monetary Fund, at the World Bank, and in trade negotiations. Oil-producing Arab states will become even more resistant to American pressures for reform of their political and economic systems, and turn increasingly to Europe and Asia to place their investments and to garner political support. It will become ever more difficult for the United States to afford military action abroad. As it is, the wars in Afghanistan and Iraq are costing the United States over \$70 billion annually. That high a level will soon become politically and economically unsupportable, and it will become clear both to Americans and to others that the United States will hesitate to act even where future threats appear to be dire.

America's standing in the world very directly hinges on what others believe the country can give to them or withhold from them. Washington can prevent a dollar-driven decline of U.S. global power by demonstrating that it has the political leadership and will to make the hard decisions necessary to sustain American economic strength. Such a demonstration must be grounded in restored budgetary responsibility. America is, at this moment, effectively an economic diabetic. Its insulin is fiscal rectitude. It will not cure the trade gap on its own, but it will allow the world to live with it by preserving the dollar as the bedrock of world commerce and finance. ♦