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The US Deficit, the EU Surplus and the World Economy

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1. Introduction

There's hardly an international economist or financial journalist who has not written about it: the US external deficit and the dire implications for the world economy if faith in the almighty dollar were to collapse. Everybody agrees that the US overseas indebtedness cannot continue growing indefinitely. But they disagree about the causes and the remedies and, most importantly, about the likelihood of catastrophe. Just as with global warming, anybody rash enough to suggest that a radical change in policy is required to avoid global meltdown is deemed to be a Cassandra. But—as a recent editorial in *The Guardian* warned—'the Cassandras may be right'.[1]

The orthodoxy in Brussels is that the EU can be proud of its economy since, in contrast to the US, the fiscal and monetary prudence shown by the Eurozone has resulted in an external surplus: growth rates may not be quite as high as the US, but the macro-economy is healthier. This sort of smug self-satisfaction is entirely unjustified. At the heart of the Eurozone's fiscal and monetary stance is a banker's consensus which values 'stability' more than output and employment growth. The cost of such orthodoxy is twofold. First, low growth and persistent unemployment threaten the EU's political coherence and social stability. Secondly—and of key importance to the argument presented below—low EU growth makes the world economy more vulnerable to a potential dollar crisis. What is needed in the Eurozone is not caution, but a far more dynamic, growth-orientated policy mix.

The conventional (and dominant) view in the OECD countries is that the US deficit is sustainable and will gradually be corrected by market-led exchange rate movements. On this reading, governments need merely pursue prudent fiscal and monetary policies to bring their own external account into balance or surplus. In reality, though, it is illogical to suggest that all countries should aim for current account balance or surplus since, to the extent some run savings surpluses, others must run savings deficits.

Below, we examine some of the key problems, looking in turn at differing interpretations that can be put upon them and the relative merits of different proposed remedies. In essence, we argue that the long US consumer boom is unsustainable, but that its cure cannot be left to the market. Devaluation alone will not do the trick; indeed, the widespread expectation of devaluation may lead to a run on the dollar with detrimental consequences for the world economy. Instead, a package of co-ordinated policy measures is needed. The main elements of such a package are managed revaluation of the major non-dollar currencies and, crucially, the reflation of the EU economy. EU reflation is seen as a necessary counterweight to any US deflation needed to re-establish a sustainable external balance.

2. The Problem

The relatively favourable growth record in recent years of the USA (compared to, say, the Eurozone) is largely explained by a long consumer boom financed by growing household borrowing and, after the stock market collapse in 2000, helped along by a large Government budget deficit. Although one hears much about the US 'twin' deficit, in reality it is a 'treble' deficit encompassing the household, government and external balances. Both the government and the private household sectors spend more than they save, and this gap is reflected in an external deficit on current account equivalent to nearly 7 per cent of GDP that must be financed from abroad. At present, the US spends about 50 percent more than it earns in the world market. In absolute terms, the 2005 current account deficit is just over $800bn, by far the largest deficit ever recorded, and it is growing.[2] To get some idea of the magnitude of this sum, if we add the external deficits of the poorest third of the world's 168 countries, the resulting figure represents barely one-twentieth of the US deficit.

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EDITOR's NOTE

This is the twenty-fourth in a series of regular *European Policy Briefs* produced by the Federal Trust. The aim of the series is to describe and analyse major controversies in the current British debate about the European Union.

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Brendan Donnelly (Director, Federal Trust)

The US trade deficit is financed by trade surpluses elsewhere in the world, chiefly those of the Eurozone, Russia, the Middle East and Asia. Why is this deficit a problem? After all, since deficits and surpluses must balance for the world as a whole, it follows that the Rest-of-the-World (RoW) must be able to finance it.

First, if the US were investing large amounts of overseas money in expanding productive capacity, we might expect the deficit to cure itself. Such investment in turn would have substantially added to world demand and been consistent with economic development elsewhere. But this is not the case: the overseas inflow finances current consumption and the acquisition of financial and residential assets. Secondly, US Government savings is negative. The US budget deficit on its own would not be terribly worrying were it not for a third factor: US households now spend more than they earn to a degree that offsets net corporate savings. Whereas, historically, the household sector was a net lender to the tune of about 2.5 per cent of national income, today households have become net borrowers of about 6 per cent of national income.[3] Clearly, any fall in household borrowing would cause the economy to contract unless offset by more spending elsewhere; eg, by Government. If financial markets worry when there is an external deficit, they worry even more when there are government and private deficits as well.

Admittedly US expansion has acted as a Keynesian 'motor' of the world economy, particularly in the 1990s when financial markets were buoyant. However, much as with a domestic business cycle, there is growing anxiety today about whether deficit-fuelled growth is sustainable. Since the US private and government sectors have ceased saving, it is foreigners who must save—chiefly by lending their savings to the US. As foreigners use their surplus dollars to purchase US assets, the US has moved from being a net creditor to a net debtor to the tune of roughly $4tr. Overseas investment in the US at the end of 2005 probably reached $14tr, about the same as the country's national income. Servicing US net indebtedness is beginning to add to the country's current deficit.

Most important, the deficit has been increasing despite an effective dollar devaluation of 17 per cent over the three-years period 2002-04. If adjustment is sought by recourse to devaluation alone, then it is clear that much larger effective devaluation is needed. But a very large devaluation would most likely be accompanied by a US—and thus a world—recession. Such a recession would hardly provide a climate conducive to US export growth. In sum, the US deficit is huge, it is growing and a precipitous cure using the price mechanism might prove very costly. What economists fear is that if financial markets become convinced that the US deficit is unsustainable, the prophecy will be self-fulfilling.

3. Why US Expansion cannot be sustained

One key factor underlying the unparalleled growth in US household debt has been the liberalisation and growth of the financial market. The stock-market boom of the 1990s morphed into the real-estate boom of the current decade, with low interest rates, rising asset prices, mortgage withdrawal and unsecured credit card debt helping to fuel faster growth in private spending than of household income. Like the asset-market bubble before it, the US house-price bubble must eventually stop growing. The only question is when we shall hear the recessionary hiss.[4] For a variety of reasons, the growth in US household spending in the past decade has been relatively painless. Rising asset values ('real balance effects') do not automatically translate into extra income; holding gains have been turned into ready cash because of the ease of re-mortgaging, and low interest rates have kept financial markets well-lubricated. But there are at least four reasons why this pattern cannot persist unchecked.[5]

First, any slowdown in asset appreciation tends to generate uncertainty about the sustainability of future gains, and hence lead to a further slowdown. Secondly, although the value of asset growth may slow or even reverse, consumer liabilities remain the same; ie, the mortgage loan for the new car or the children's education must be repaid. Moreover, under conditions of very low inflation, the value of household debt erodes only slowly.

Thirdly, although a slowdown in private spending can be offset by an increase in government spending, the scope for such counter-cyclical policy has been reduced by the Bush administration. When the stock-market bubble bust in 2001, Washington responded by lowering interest rates and granting swingeing tax cuts for the rich.

Washington's monetary stance has since tightened, thus providing scope for renewed loosening. But the fiscal giveaway had two key drawbacks. Tax cuts were poorly targeted and had minimal multiplier effects, and tax cuts cannot easily be clawed back, so narrowing the scope for Government to prime the pump in future. The budget deficit is well in excess of the 3 per cent limit that orthodox economists deem it prudent for a country to observe while the net liability position is about 50 per cent of GDP. In short, if the private household sector cuts its own spending and returns to a sustainable savings path, government must run ever growing deficits to sustain aggregate demand at a time when the scope for so doing has greatly diminished.

Of course, the US economy might be rescued by increased investment in the corporate sector. But this escape route is blocked by two factors. One is the prospect of slackening domestic demand deterring the growth in new investment—and with it, the growth of labour productivity.[6] And even assuming domestic demand is not a constraint on investment, another problem is that the ownership of US corporations is increasingly in foreign hands. As the US external deficit is recycled and used to purchase US assets, the flow of repatriated profits (ie, the required yield on those assets) will increase, constituting a growing leakage out of US income, in turn resulting in a smaller investment multiplier. In short, the increased probability of a weaker dollar and the prospect of a US slowdown is not merely the mechanical outcome growth in the US trade gap. The likely slowdown in the US economy is underlain by the unsustainable nature of the growth path itself.

4. Why Market Forces Alone cannot correct the Problem

The response of the Bush administration to growing external debt has been confused. The Treasury Secretary appears to believe in a 'strong dollar' solution sustained by increases in productivity resulting from a synergy between the foreign capital keen to invest in the US and the resilience of 'corporate America'. The Federal Reserve appears keener on market-led exchange rate adjustment. This response mirrors the IMF view which, succinctly stated, is that a full-employment growth path is sustainable as long as governments practice fiscal and monetary restraint and prices—chiefly the prices of foreign exchange and labour—are allowed to adjust freely. While the precise degree of devaluation required is not stated, the unofficial view in Washington is that a real dollar devaluation of about 15 per cent would suffice to restore overall trade balance.

There are four main reasons why exchange rate adjustment alone cannot restore balance. First, a number of US trading partners (eg, China, Malaysia, Hong Kong) have effectively pegged their currencies to the dollar—the modern version of the competitive devaluations of the 1930s—and are unlikely to be persuaded to accept the slowdown in export-led growth that currency revaluation would entail. Secondly, as numerous analysts have pointed out, the real fall in the dollar relative to the 1990s has not led to an external account improvement. Cripps et al. (2005) argue that despite a 17 per cent effective depreciation of the dollar in 2002-04, the external account continued to deteriorate.[7] This may be due in part to the fact that dollar depreciation has a 'wealth effect'. When the real value of the dollar falls, US holders of (say) euro-denominated assets gain and consequently feel richer and continue spending. This effect could in principle be amplified by the fact that non-US holders of dollars would experience a concurrent 'holding loss' discouraging spending, and thus weakening US export demand.

Finally, the trade gap is simply too large. On our estimate, exports would need to grow 3 per cent faster than imports for fifteen years merely to bring US exports and imports to balance. Such a turn-around could not be engineered by price-adjustment alone but would require constraining import growth via a slowdown in economic activity. But an adjustment induced by stagnation or recession would be painful not just for the US; it is undesirable because it would threaten the international economy as a whole. In sum, while exchange rate adjustment may be desirable, it needs to be accompanied by decreased absorption in the US and increased absorption in the Rest-of-the-World (RoW).[8]

5. What of Europe?

Continued growth of the world economy has been facilitated because Government and households in the US spend more than they earn. The resulting buoyancy in world demand has been sufficient to allow governments and households in the EU and elsewhere to be 'prudent'. This basic principle is often forgotten in comparing the US and EU growth records. Although some EU-15 countries are in deficit—eg, the UK, Spain, Italy, Portugal and Greece—collectively, the EU countries run a surplus on current account transactions with the rest of the world, a fact explained largely by Germany's export performance. In 2004, Germany overtook the United States in the total value of its exports. Over the past 10 years the EU-15's exports to the rest of the world have increased from 7 to 11 percent of total GDP; in the US, by contrast, the share of exports in GDP over the same period has stagnated.

In this respect, Britain resembles the US more than the Eurozone. Like the US, Britain's growth record over the past decade has been better than that of the Eurozone. Although Gordon Brown's management of Government finances has been more prudent than that of his US counterpart, the UK runs a sizeable visible trade deficit which is financed by inflows of foreign capital. Britain's sustained growth in recent years is explained only in part by an increase in expenditure on public services; in the main, it is explained by strong household spending facilitated by house price appreciation. Indeed, as asset price appreciation slowed in 2005, the Treasury's projected GDP growth figures for 2006 were revised downward and show growth falling slightly below the Eurozone average.

6. Restoring Word Economic Balance

The question remains: how is balance to be restored to the world economy? The conventional wisdom is that the cheaper dollar will eventually bring about adjustment. While exchange rate adjustment is necessary, we have argued both that it is weak and insufficient instrument and that a sustainable and effective correction would need to be carefully managed. Like the stock market, the foreign exchange market depends on sentiment, which is notoriously volatile and can lead to over-adjustment. In place of the current policy of benign neglect of the dollar, international action is needed to move towards a set of exchange rates between the main trading blocs compatible with full employment and resulting in manageable inter-regional surpluses and deficits.

Price adjustment could only be successful if complemented by consistent quantity adjustment. Quantity adjustment is conventionally taken to mean that US consumers must reduce their expenditure on foreign imports—tighten their belts— in order to free resources for exports. But harsh belt tightening in the US under conditions of universal fiscal and monetary prudence can only lead to world economic stagnation and possible recession. The essential point is that quantity adjustment needs to be expansionary; ie, the rest of the world must be able to absorb the US deficit. Since US imports are growing steadily at about US$ 250 bn per year and exports at about US$ 100bn, a *full* correction of the current account which avoids US recession requires the rest of the world to absorb about US$ 900bn of exports ($750+$250-$100 bn) today and even more in future years. It is difficult to see this happening without significant world economic acceleration.[9] In practice, 'adjustment' requires immediate action both to move towards more realistic exchange rates and maintain high levels of aggregate demand for tradable goods. But even if one aims at a partial correction of the US external imbalance, the quantities involved are enormous and will not come about without shaking up current institutions and effecting a change in the US mindset. The reallocation of surpluses and financing to generate demand and employment in the world as a whole may be a difficult balancing act, but it is not impossible.

The main surplus countries are Germany and Japan who together absorb over 40 per cent of the US deficit, with Russia, Saudi Arabia and China together accounting for a further one-third. Russia and Saudi Arabia are large energy exporters, and their surpluses can be treated as a derived demand from industrial expansion elsewhere; ie, chiefly the EU and Asia. Since growth in China is already very high, little more need be said other than to express some question about how long the current rate can be maintained. What of Japan and Germany? In Japan, after fifteen years of stagnation and five of deflation, a looser fiscal and monetary stance seems at last to be producing conditions favourable to sustained growth.[10] By contrast, after five years of very slow growth in Germany, a slight improvement in performance in the past year appears to have produced dismay at the ECB, which in March 2006 raised its interest rate and once again is warning member-states against budget deficits.

Germany's poor growth performance is explained not just by the drag on the economy of sustaining sizeable continued transfers to the east, but also by the dysfunctional nature of the Eurozone arrangements for macroeconomic management. There is little doubt that the poor performance of the Eurozone as a whole derives in good measure from the straightjacket on aggregate demand imposed by the Stability and Growth Pact and the central monetary authority's exclusive concern with inflation targeting.

There is a significant and growing literature on how Eurozone macro-economic policy and institutions might be shifted in favour of expansionary fiscal policy and a more in favour of expansionary fiscal policy and a more inflation-tolerant monetary policy to which the authors have contributed elsewhere; in consequence only a few points will be made here.[11] First, the ECB currently lacks an exchange rate policy; it could usefully take the lead in bringing together the US and its main trading partners to thrash out a medium- and long-term view of sustainable exchange rates for the major trading blocs under different growth scenarios. Secondly, the Eurozone needs far more robust fiscal arrangements. If SGP-constrained automatic stabilisers at member-state level have proved too weak to lift the main Eurozone states out of stagnation over the past five years; they provide almost no protection against a large external shock caused by a run on the dollar. In addition to scrapping the SGP (concentrating instead on sustainable levels of public debt), the EU budget must be large and flexible enough to play a counter-cyclical role as first suggested in the MacDougall report.[12] Minimally, this would mean funding the budget through a combination of progressive taxation, ECB *seignorage* and EU Treasury borrowing; in the longer term, the central fiscal authority should contribute to the fiscal robustness and universality of social insurance and pensions throughout the EU.[13] Most important, a long-term investment programme in social and economic infrastructure would provide both a major stimulus to growth and help meet the Lisbon targets; the need for such a programme was clearly envisaged in the Delors While Paper of 1993.[14]

A crucial qualification concerns Europe's finding an alternative to the US and UK growth strategies. 'Anglo-Saxon' growth, as already seen, has been driven by a boom in private spending sustained by rising asset prices. The role of Government has been confined largely to keeping interest rates low by capping public borrowing, and to promoting liberalised credit markets enabling holding gains to be converted to ready cash. Recently, professional discussion has focussed on whether or not Government (particularly in the US) has been too discretionary in fiscal and monetary matters, about how and when to rein in irrational exuberance, about supply-side 'flexibility' and so on. Almost nothing has been said about the relatively low levels of productive (private and public) investment, the decline in manufacturing relative to financial sector activity and the growing household income dispersion accompanying the Anglo-Saxon consumer boom. The above suggestions for EU reflation would right this imbalance.

There is emerging evidence that some Eurozone countries may be moving in the direction of a US-style debt-fuelled growth; eg, in Ireland, France, Spain (and to a lesser degree in Italy), rising house prices have sparked an increase in spending which appears to be spilling over into the external balance.[15] Moreover, in some countries (eg, Denmark) the link between financial deregulation and a house-price boom is clear—and potentially more destabilising than running an 'excessive' government deficit. Asset-inflation led growth must be distinguished from the classically Keynesian path led by public investment and social provision which facilitates private investment in cutting-edge industries, precisely where comparative advantage can be established and new exports promoted. If slowdown in the US is to be offset by accelerated growth in the Eurozone, it is vital to consider what constitutes a sustainable growth path.

7. Conclusion

The world economy has entered a new phase of potential instability. The growing deficit in the US must by definition be offset by growing surpluses elsewhere. Underlying these flows is a burgeoning and volatile world capital market; cumulating stocks of appreciating net assets in whose value is maintained and contested between governments, corporations and households; and an international market for goods and services whose locus of production is drawn towards cheap labour. Since exchange rate adjustment is today relatively weak and politically constrained, no market mechanism exists for checking world trade imbalances. If world recession is to be avoided, it has become imperative to seek co-operative solutions between trading blocks in which surplus countries accelerate their growth in order to facilitate adjustment by deficit countries. This logic runs counter to the current deflationary orthodoxy.

The debate in the UK about the potentially constraining nature of the Golden Rule—like the debate in the Eurozone about the constraint on growth imposed by the Stability and Growth Pact—has important implications for the world economy as a whole. European (including UK) growth is required not merely to reduce European unemployment, but to counteract the danger of world recession posed by the US external deficit. World trade deficits and surpluses can only be managed by careful policy co-ordination between the regions concerned, a role Keynes envisaged for the IMF at the time of its founding in 1944. In practice, this role has been relegated to free markets and to central bankers. But in today's world, exchange rates must be negotiated and managed with care, and trade flows must not be disrupted by deflationary policies. Most important, if it is vital for the Eurozone to grow, it is equally vital that the chosen growth path be more equitable and sustainable than that observed in the USA over the past decade.

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[1] See *The Guardian*, 'What if the Cassandras are right?' Monday, 20 Feb 2006.
[2] The figure of $805bn is from the US Department of Economic Affairs (DEA). It is equivalent to over 7% of national income or 20% of (general) government spending. See IMF, International Financial Statistics, 2006 and US DEA, News Release, 14 March 2006.
[3] One must distinguish household consumption from household spending; the latter is defined as consumption plus residential investment. Much of the confusion about financial balances in the US is precisely because most people do not realize that households must borrow if total spending, not merely consumption, is greater than income.
[4] See Paul Krugman, 'The Hissing Sound' *The New York Times*, Op-Ed, 8 August 2005.
[5] For a comprehensive and prescient discussion of 'sustainability' see W Godley (1999) 'Seven Unsustainable Processes: Medium-Term Prospects and Policies for the United States and the World.' Special Report, Annandale-on-the-Hudson, New York: The Levy Economics Institute of Bard College.
[6] One assumes here that 'labour productivity' growth arises from equipping the workforce with more machines under conditions of buoyant aggregate demand.
[7] See F Cripps, J Eatwell and A Izurieta, 'Financial Imbalances in the World Economy' *Economic and Political Weekly*, December 24, 2005.
[8] The evidence so far seems to suggest that while holding gains have a real balance effect, holding losses do not seem to impact negatively on spending with the same force. This may help explain why a strong dollar has not discouraged spending in the US despite a loss of foreign-denominated wealth.
[9] See W Godley and A Izurieta (2004) 'Balances, Imbalances and Fiscal Targets: a new Cambridge View' Cambridge Endowment for Research and Finance (CERF); Judge Institute, Cambridge. Also see G Irvin (2006) *Regaining Europe*, London: Federal Trust.
[10] At the time of writing, the Bank of Japan is celebrating the first signs of the end of deflation by announcing a possible rise in interest rates! See J McCurry 'Bank of Japan prepares to raise interest rates after five years at near-zero' *The Guardian*, March 10, 2006.
[11]See for example G Irvin (2006), *Regaining Europe*, London: Federal Trust; Goodhart, CAE (2006) 'Replacing the SGP?' draft paper to the *Franklin Conference on the Future of Europe*, Lugano, March 2-4.
[12] For an excellent discussion of this matter see J Grieve Smith (2005) 'Unemployment and Fiscal Policy in the EU', *European Policy Brief* 17, London: The Federal Trust, November; also CAE Goodhart (2006) *op cit.*
[13] The MacDougall Report (1997) called for an initial federal budget amounting to 2% of EU GDP and rising to 5-7%. A separate commission reporting in 1993 called for a European Fiscal Transfer Scheme (EFTS) to cushion the currency area from external asymmetric shocks; see European Commission (1993), Monnaie Stable – Finances Saines: Les Finances Publiques de la Communauté dans la Perspective de l'UEM, *Economie Européene*, n. 53.
[14] See European Commission (1993) 'Growth Competitiveness and Employment' (Delors White Paper). Luxembourg.
[15] See M Ball (2006) *European Housing Review*, London: Royal Institute of Chartered Surveyors; Ball finds that financial liberalisation is one factor contributing to rising house prices, though he finds constrained supply most important. Equally interesting, Ball suggests that rapidly rising house prices are associated with rising income inequality. Also see OECD (2005), *World Economic Outlook* No. 78, December.