Economic Consequences of Continued U.S. External Deficits

The U.S. external deficit is commonly viewed as one of this country's most serious economic problems—and indeed a problem for the rest of the world as well. This judgment is based upon the widespread presumption that ongoing external deficits are harmful and ultimately unsustainable, a view that seems amply supported by the inflation and other economic disruptions that have often afflicted deficit nations in the past. Many observers have warned that intensified pressures on the dollar, reductions in future living standards, and other serious consequences are almost unavoidable unless fundamental policy actions are taken to bring the imbalance down; they warn further that these problems will become increasingly severe the longer the current account deficit persists.

Not all observers, however, agree that the U.S. deficit is necessarily harmful. Although a few even contend that the deficit is beneficial, the main thrust of the skeptics' argument is that the problems of financing and adjusting to the external imbalance have been misstated and exaggerated.[1] Some proponents of this view maintain that the deficit is sustainable, at least in principle, and that market forces will make any adjustments needed to restore equilibrium to the external accounts. Others contend that the preeminent position of the United States and the dollar in the international economy enable this country to run persistent deficits while avoiding the problems afflicting deficit nations in the past. Pointing to the continued robust performance of the U.S. economy, these analysts in effect ask: Is the current account deficit really a serious problem, and are major policy steps to reduce the deficit necessary or desirable?

This article evaluates the economic consequences likely to follow from continued large U.S. external, or current account, deficits. The basic conclusion is that such deficits do represent a serious economic problem. Continued large U.S. deficits are likely to lead to longer term problems in large part associated with the financing of the deficits, and to impose adjustment costs arising from the macroeconomic changes in spending, exchange rates, and other variables needed to restore equilibrium. Moreover, the costs will probably increase, as will the potential risks to the economy's financial and macroeconomic stability, the longer the deficits persist. The skeptics admittedly have raised some legitimate questions about the exact nature of these problems and about the adjustments needed to restore equilibrium to the external sector. Their arguments do not, however, make a plausible case for benign neglect of the current account deficit.

The first section of the article, a review of the issues under debate, explains that there is general agreement on the basic nature of the deficit: the external deficit is a reflection of macroeconomic imbalances between domestic spending and national income and between national saving and investment. Controversy about the deficits has largely centered on their sustainability and the long-term implications of U.S. external indebtedness, the need for policy actions to achieve external adjustment to equilibrium, and the extent to which the

[1] Herbert Stein, for example, has expressed doubts about the alleged problem of the external deficit and the need for government action to remedy it. See "A Primer on the Other Deficit," *AEI Economist*, March 1987, and the related argument in "The World Economy Doesn't Hang in the Balance," *Wall Street Journal*, December 30, 1987.

required changes are likely to become more severe the longer the adjustment is postponed.

The second section argues that the external deficit is theoretically sustainable, but primarily in a technical sense. In practice, the accumulation of U.S. external debt from continued large deficits may well lead to significant increases in domestic real interest rates and other financial strains. These problems are likely to intensify with further growth in the debt relative to foreign wealth. Moreover, the imbalances now making up most of the external deficit—between merchandise imports and exports and between aggregate spending and national output—cannot be sustained. Eventually, the supply of foreign savings that now finances these gaps will abate as our foreign borrowing increasingly goes to debt service. The United States will then be faced with the choice of restraining private consumption and government spending or suffering a decline in capital formation and consequent erosion of future productivity and living standards.

The question, therefore, is not whether substantial adjustments must be made to restore external equilibrium, but how and when they will be made and at what cost. The macroeconomic changes needed for the adjustment, described in the last section, will inevitably entail a significant slowdown in real spending from recent trends and potentially increase the problems and risks faced by policy makers in maintaining full employment and price stability. Like the financial consequences of U.S. foreign debt, these adjustment costs are likely to become increasingly serious the longer large external deficits persist. Moreover, the adjustment to long-term equilibrium is likely to occur only very slowly, and indeed may not continue, unless policy actions beyond those already enacted are taken. For these reasons, at least, benign neglect toward the U.S. external balance is apt to prove an increasingly problematic and risky course.

Terms of the debate

The debate over the U.S. current account deficit is not about fundamental economic concepts. Virtually all analysts, regardless of their views, agree on the basic nature of the external imbalance and the general forces underlying it. The disagreements center on the specifics of the U.S. deficit, namely its precise causes and its particular economic consequences.

By definition, the current account (external) balance is the difference between a nation's sales (exports) of goods and services to foreigners and its purchases (imports) from foreigners of similar goods and services. The services include factor payments—interest, dividends, and remittances—for the services of capital and labor. For the present discussion, the trade balance can be viewed as the current account balance excluding net payments on the nation's foreign indebtedness.[2]

The current account is essentially a macroeconomic balance between national savings and investment or, equivalently, between national income and spending. That is, to the extent that a nation exports more goods and services than it imports, it must lend the difference by acquiring an equal amount of (net) claims on foreigners. Net lending to foreign nations represents the difference between national income, Y, and national spending, A, which is also the same as the gap between national saving and investment, I. National saving refers to the total of private and public saving, that is, the difference between private saving, S, and the public sector budget deficit, D.

From this perspective, the present U.S. current account deficit, CA, reflects the excess of private and public spending relative to this nation's income and an equal shortage of private domestic savings relative to the domestic demands for that saving from private investment and the general government deficit; these gaps are being financed by net borrowing from abroad, which can be viewed as a net import of foreign saving:

$$1)\quad CA = A - Y = I + D - S.$$

The trade deficit as defined above can be described in similar macroeconomic terms as the gap between national spending and output.[3]

Table 1 illustrates how last year's current account deficit of about 2.7 percent of GNP is accounted for on this basis. In 1981, the last year the United States recorded a surplus, national saving and investment were higher in relation to GNP (and the government deficit lower) than now, but the gap between them was virtually negligible. The present deficit reflects a substantial decline in the national savings rate (from both public and private sources) that has more than offset a modest drop in the (gross) investment rate.

This macroeconomic view does not, of course, mean that trade barriers, productivity, quality, and other determinants of national competitiveness have no role in overall U.S. trade performance. In many cases,

[2]By this definition, the trade balance includes certain nonfactor service items, such as travel and transportation, which can be ignored in most of the discussion. The balance of trade in goods only will be referred to as the merchandise balance.

[3]This follows from the fact that, ignoring transfer payments and labor remittances, GNP is equal to national output (gross domestic product or GDP) less net investment payments to other countries. Thus the trade deficit is only approximately equal to the gap between GDP and aggregate spending, although the discrepancy is fairly small.

these factors will affect national savings and investment and hence influence the external balance; moreover, such factors will, at the least, help determine the configuration of exchange rates and other proximate economic conditions consistent with any given balance.

More generally, neither the above identities nor the figures in Table 1 themselves reveal the ultimate causes of the U.S. external deficit, and indeed the relations are compatible with a wide range of alternative explanations. Moreover, the deficit is clearly the (endogenous) result of the basic exogenous factors determining national saving, investment, income, and spending. In this sense, any problems or other consequences associated with the deficit are fundamentally attributable to the macroeconomic forces underlying it.

Disputed issues

Ultimately at issue in the debate over the external deficit are the net overall benefits of measures to reduce the imbalance compared with those of alternative courses—including benign neglect. This most basic question cannot be resolved, however, without first determining the precise consequences of the deficit and evaluating whether and to what extent they are likely to be problematic.

Despite fierce debate over the issue, the question of what to do about the deficit does not depend exclusively or even mainly on its origins. Some proponents of supply-side economic policies have maintained that the external deficit is largely attributable to an improvement in the U.S. investment climate relative to that of other nations. This improvement stemmed in part from business tax deductions enacted in 1982 and allegedly had the effect of attracting foreign capital to this country. The balance of evidence, however, favors the more conventional view that the external deficit is mainly the result of a decline in national savings due to the federal budget deficit and the drop in household saving, reinforced by weakness in demand abroad.[4] Nonetheless, the first view, even if correct, does not necessarily imply that policy makers can safely ignore the external imbalance; measures to reduce the deficit still may be needed if problems arising from its financing and other consequences are sufficiently great. More generally, policies toward the deficit need to be based on current and likely future economic circumstances and not simply on past developments: reversing all the individual historical forces that caused the deficit may not be desirable or even feasible.[5]

Much of the controversy about the implications of continued U.S. deficits concerns their financing. By official estimates, the book value of U.S. net indebtedness to foreign private and public entities, in the form of bank loans and deposits, bonds and other securities, and direct investment claims, is now nearly $500 billion and rising rapidly.[6] Servicing this debt entails a continuing stream of interest and dividend payments to foreign countries; these payments (a debit item in the current account) will almost surely increase as the indebtedness accumulates.

To many observers, continued financing of large U.S. external deficits is inherently unsustainable. Those viewing the deficit as a major problem worry especially about limitations on foreigners' ability and willingness

Table 1

Sources of the U.S. External Deficit

(Percent of GNP)

	1973-79 (average)	1981	1986	1988
Gross national saving	17.1	17.1	12.6	13.2
Private household	5.6	5.2	3.1	3.0
Private business	12.4	12.8	13.0	12.0
Government surplus†	−0.9	−1.0	−3.5	−1.8
Gross domestic investment	16.8	16.9	15.8	15.8
Memo: Current account balance/GNP†	0.1	0.2	−3.3	−2.7

Notes: The difference between national saving and investment does not exactly equal the current account balance because of a small statistical discrepancy.
†(−)indicates a deficit.

[4]In particular, both national and household savings rates have been significantly lower over the last several years than in the 1970s and 1960s. In contrast, gross investment as a share of GNP has been about equal to its pre-1982 average, while net investment has been noticeably lower.

[5]Many economists believe that it would be highly desirable to raise private saving. There is little evidence, however, that policy can affect the private savings rate appreciably. If so, a significant increase in national saving is likely to be achievable only if the public sector's deficit is reduced.

[6]The true market value of the U.S. international investment position may differ considerably from its book value as reported by the U.S. Department of Commerce. Several studies indicate that the market value of U.S. net direct investment claims are substantially understated by the book value figures. For example, see Lois Stekler, "Adequacy of International Transactions and Position Data for Policy Coordination," Board of Governors of the Federal Reserve System, International Finance Discussion Papers, no. 337, November 1988. There is also considerable evidence, however, that a significant portion of the errors and omissions in the U.S. balance of payments data over the last six years reflect borrowing from foreigners that is not recorded in reported capital inflows or the net investment position. In any case, it is the increase of at least $600 billion in U.S. net obligations to other countries over the last six years that is of primary significance here.

to continue to lend to the United States and the risks of a crisis should those limits be approached. For example, Steven Marris in a 1985 monograph predicted a "dollar crash" leading to U.S. inflation and recession on this basis.[7] Apart from the sustainability of the external debt growth, there is considerable concern about its ongoing consequences, in particular the burden imposed on future generations' living standards by the servicing of the indebtedness as well as the potential financial strains arising from large and growing foreign holdings of U.S. assets.

In contrast, those taking a more benign view of the deficit argue that it is sustainable, at least in principle, and that market forces will be sufficient to ensure that necessary financing will be available without undue strain.[8] The implication is that explicit policy actions are not necessary to restore equilibrium to the current account. Others argue that foreigners have no choice but to lend their excess savings to the United States, or that this country, by virtue of its size and the dollar's role in the world economy, is uniquely able to borrow from abroad indefinitely. We will see in the next section, however, that while the problems of financing the U.S. deficit may be different from those encountered by other countries in the past, they are not necessarily any less problematic.

The financial consequences of the deficit can be thought of as ongoing in the sense that they are the legacy of the stock of debt accumulated by past deficits and hence need not disappear (at least at first) if the current account is brought back to balance. A second set of concerns is focused on the adjustments in macroeconomic variables associated with the creation of the deficit and its subsequent evolution. That is, a current account deficit is the result in a proximate sense of changes in domestic demand, prices, interest rates, exchange rates, and other economic conditions that constitute the linkages between the underlying macroeconomic imbalances and the external accounts.

For example, most observers would agree that the rapid growth of U.S. domestic demand relative to foreign demand after 1982 and the sharp rise in the real value of the dollar were major proximate contributors to the development of the trade and current account deficit.[9] Likewise, the creation of the deficit also involved an effective contraction of activity in traded-goods (mainly manufacturing) sectors relative to nontraded-goods industries such as housing and services. Any future reduction of the U.S. external deficit is apt to entail at least a partial reversal of many of these changes, the consequences of which are apt to be partly beneficial and partly problematic. Among the chief concerns about these adjustments are the implied reduction in the growth of domestic spending and living standards, and the potential deterioration in trade-offs between price stability and real growth that may arise from the required macroeconomic changes.

A key contention of those viewing the deficit as a pressing problem is that the ongoing and adjustment costs are closely related and likely to become increasingly severe the longer the imbalances continue. These points are especially evident from several recent analyses that assume (on the presumption that an ongoing deficit is unsustainable) that the current account must ultimately return to balance.[10] Because of the debt accumulation, achieving such balance is likely to become progressively more difficult the longer the deficit persists: the larger the external debt, the greater the trade surplus needed to meet the debt service payments. A hysteresis thus may arise from continued deficits, in the sense that the adjustments in the dollar and other macroecomic variables needed to restore equilibrium to the current account become more severe the longer they are postponed. In the following two sections, which discuss these ongoing and adjustment implications of the deficit in more detail, we will see that a hysteresis may well occur even if a current account deficit can be sustained.

Ongoing financing problems of the deficit

At present borrowing rates, the U.S. could add more than $500 billion to its foreign indebtedness over the next five years. An external debt of this magnitude would be historically unprecedented, both in size and in relation to foreign wealth; servicing the debt could eventually absorb 1 percent or more of this country's GNP. Thus it is not surprising that the financing of the U.S. current account deficit has led to much concern

[7]See Steven Marris, *Deficits and the Dollar: the World Economy at Risk*, Institute for International Economics, Monograph no. 15, December 1985.

[8]Stein ("The World Economy") admits the possibility of a "dollar crash" scenario involving sharp domestic interest rate increases but argues that its deflationary effects can be offset by monetary policy. This seems somewhat optimistic in view of the lags in private economic behavior and policy makers' perceptions and actions.

[9]Analysts differ more on the relative importance of the various proximate factors, such as the contribution of interest rates to the dollar's rise.

[10]A good example is Jeffrey Sachs' analysis of the sacrifice ratio of output gains to inflation in the creation of the deficit and its subsequent reversal. See Jeffrey Sachs, "The Dollar and the Policy Mix," *Brookings Papers on Economic Activity*, 1:1985. Similar reasoning underlies John Williamson's calculations of equilibrium dollar exchange rates (*The Exchange Rate System*, Institute for International Economics, Monograph no. 5, September 1983).

and controversy.

Three basic and closely related issues are raised by this financing. The first concerns whether continued U.S. deficits are sustainable. The answer to this question largely determines whether the current account must necessarily return to balance or not. A second issue, less often mentioned but in a sense more fundamental, is the ongoing financial consequences for U.S. interest rates and financial market conditions of increasing levels of U.S. indebtedness. The third issue concerns the long-term implications of the debt for future U.S. wealth and living standards.

The sustainability question

The view that the U.S. external imbalance is inherently unsustainable is very widespread, although not, as we have seen, undisputed. Claims are often heard that foreigners will eventually run out of funds to finance the current account deficit or will become saturated with U.S. debt. These assertions are oversimplified: the current account deficit is sustainable in a technical sense. Of more practical significance, however, is that the present trade deficit and the imbalance between spending and national output underlying it are not sustainable even in theory.

Technically, there is no reason why the United States or any other nation could not run a current account deficit indefinitely. Assertions that foreigners will run out of funds to purchase U.S. assets ignore the fact that the world economy is growing so that the resources available for lending are continuously increasing. In such an environment, a current account deficit is theoretically sustainable as long as the resulting debt to foreigners eventually stabilizes relative to income and wealth. The technical requirements for this stability are explained in the accompanying Box. A current account deficit that remains constant relative to GNP will eventually lead to a stable debt-GNP ratio, a point illustrated in Table 2.[11]

In another important respect, though, the present U.S. current account position is unsustainable. Because servicing payments will rise as the external debt accumulates, maintaining the current account deficit at a constant ratio of GNP will require a decline in the trade portion of the deficit, that is, the deficit excluding net interest payments. The Box shows in fact that if the interest rate paid on foreign indebtedness just equals the nominal growth rate of the economy, the trade account will ultimately have to be balanced for the current account to be sustainable. In this case, the current account eventually just equals the debt service payments, with the debtor nation in effect borrowing the net interest due. If the interest rate exceeds the growth rate, then the trade account must be in surplus to help pay the servicing costs.[12]

These technical observations have some important practical implications. First, as just noted, the U.S. current account need not necessarily return to balance to restore equilibrium to the U.S. external sector.[13] Indeed, the longer the present current account imbalance persists, the higher the debt and debt service payments will become, and the greater the likelihood that the U.S. will become a persistent deficit nation.

Even more important, however, is that most of the adjustments deemed necessary to balance the current account will have to be made even if the current account remains in deficit. The 1988 U.S. trade deficit was about $135 billion, virtually the same as the overall current account deficit. Bringing this large trade deficit back to balance will require substantial adjustments in trade flows, in U.S. and foreign incomes, and in other macroeconomic variables. Moreover, the present situation, in which borrowing from abroad is effectively financing an aggregate spending level nearly 3 percent greater than output, must also cease eventually. As this borrowing is increasingly devoted to servicing the external debt rather than financing domestic spending, this country will be faced with a choice between restraining private consumption and government spending or allowing a decline in the rate of domestic capital formation. Clearly, therefore, the meaningful question is not whether substantial adjustments in the external accounts should be undertaken, but when, how rapidly, and under what circumstances they are to occur.

[11]Of course, a current account deficit cannot absorb more than all available foreign funds (or, more practically, the bulk), nor can the external debt exceed total foreign wealth. Even the most pessimistic projections of the U.S. external deficit and debt are well below such technical limits, however.

[12]The measured return on the book value of U.S. investments abroad has typically been significantly greater than that on foreign investments here. Last year, the gap in the two returns was so great that U.S. net service payments were virtually zero despite an officially estimated debt of well over $400 billion. It is possible, although by no means certain, that this country's rate of return on its assets will continue to exceed that paid on foreign liabilities (although not nearly to the degree recorded in 1988). If so, the effective interest rate on U.S. net external debt could remain below the economy's growth rate, making an ongoing trade deficit a technical possibility; this deficit is likely to be fairly small in relation to GNP, however (see Box).

[13]Will the present imbalances between national saving and investment and between spending and income stabilize or rise relative to GNP? We can be reasonably assured, based on past experience, that the gap between *private* saving and investment, which is generally small, will remain stable. Whether the public sector budget deficit will fall (as it has in the last two years) or resume increasing relative to GNP will depend upon policy choices. Stability in the deficit-GNP ratio is not automatic and indeed involves essentially the same technical conditions as apply to the external imbalance (that is, balance or near-balance in the budget excluding interest payments on national debt).

Box: Technical Aspects of Current Account Sustainability

This box explains in more detail the technical aspects of current account sustainability and related implications summarized in the text. For the most part, the conclusions are directly analogous to more often discussed observations concerning the sustainability of public sector budget deficits.

A current account deficit can be sustainable only if it leads eventually to a stable ratio of external debt, D, to domestic GNP, Y, and foreign wealth, which for simplicity will be assumed to grow at the same rate. (The basic conclusions are easily generalized when the growth rates differ.) This means that eventually:

$$1)\ D'/D = Y'/Y = g,$$

where D'/D, the proportional growth rate of the nominal external debt (D' is its absolute change), must equal the nominal GNP growth rate, Y'/Y, or g, expressed in decimals. Suppose now that the current account deficit to GNP ratio is stable at some ratio $(CA/Y)^*$. (Note that a deficit corresponds to a positive value of CA.) This corresponds to a stable long-term equilibrium debt/GNP ratio of $(D/Y)^*$ that follows directly from relation 1 (multiply each side by Y/D and note that, ignoring valuation changes, CA = D'):

$$2)\ (D/Y)^* = (CA/Y)^* \div g.$$

Thus the long-term debt ratio is greater the larger the sustained CA in relation to GNP and the lower the country's nominal growth rate.

To determine the relation between the long-term current account and the debt servicing, suppose that the nominal interest rate paid on the net indebtedness is "r" so that debt service payments are $r(D/Y)^*$. The trade deficit, T, is simply the difference between the overall current account and this debt service:

$$(T/Y)^* = (CA/Y)^* - r(D/Y)^*.$$

We can express this in terms of the current account/income ratio as:

$$3)\ (T/Y)^* = (1 - r/g)(CA/Y)^*.$$

It follows that if the interest rate just equals the GNP growth rate, the trade balance must ultimately be in balance, leaving the entire current account deficit to service the external debt. If the interest rate paid exceeds (is less than) the growth rate, the long-term equilibrium trade balance must be in surplus (deficit).

As noted in the text, the point is of potentially significant practical importance because of its implications for the ultimate servicing of the external debt and for the adjustments needed to ensure the sustainability of the current account itself. Recall that the current account is the difference between GNP and national expenditure, A; GNP, or national income, is itself equal to the value of national output or gross domestic product, "Q," less net factor payments to foreign countries. With some inessential oversimplification (ignoring labor remittances and other factor payments unrelated to the external debt), this means that the trade deficit is simply the difference between national output and expenditure, so that eventually:

$$4)\ (T/Y)^* = (A/Y)^* - (Q/Y)^*.$$

To understand the significance of these relations, suppose that a nation having no external debt begins incurring a trade and current account deficit. Initially, of course, this means that national spending exceeds both national income and output. But as the trade deficit subsequently declines, the initial gap between output and spending must close, even if that between income and spending (that is, a current account deficit) remains. For example, if the interest rate equals the economy's growth rate, national expenditure must eventually come back to equal output. That is, in the long run, national output goes entirely to national spending, as it did before the current account imbalance developed. Note, however, that national income will have fallen relative to output by the amount of the long-run debt servicing.

Hypothetical Equilibrium Trade Balance Configurations

(Assuming Nominal GNP Growth of 7.5 Percent per Year)

Trade Surplus/GNP (Percent)	Nominal Interest Rate			
	6.0	7.5	9.0	11.0
With CA/GNP ratio				
of 1 percent	−0.2	0	0.2	0.5
of 2.5 percent	−0.5	0	0.5	1.2
of 4.0 percent	−0.8	0	0.8	1.9

Notes: Figures calculated from relation 3 in the text of the Box. CA refers to the current account *deficit*.
(−) indicates a deficit in the trade balance.

Box: Technical Aspects of Current Account Sustainability *(continued)*

In contrast, if the interest rate exceeds the growth rate, national expenditure must eventually fall below real output, part of which is devoted to servicing the external debt. Both the ultimate reduction in national spending and the macroeconomic adjustments needed to bring it about will be greater in this case than when the interest rate is equal to or below the growth rate. (Of course, if the interest rate is less than the growth rate, the nation may be able to maintain a permanent deficit in trade and expenditure above the level of output.) Hypothetical illustrations of the potential size of the trade surplus imposed by the debt-service burden are given in the table. Clearly this burden will be less than would be the case if the current account itself had to return to balance, but it could nonetheless be significant.

Table 2

Consistent Long-Run Rates of Debt and Deficit Ratios to GNP

Net Foreign Debt/GNP (Percent)	Long-Run Deficit/GNP Ratio (Percent)		
	1	2.5	4
With nominal GNP growth of 7.5 percent	13	33	53
With nominal GNP growth of 10.0 percent	10	25	40

Note: Figures calculated according to formula: debt/GNP = (deficit/GNP) ÷ g, where g is the nominal GNP growth rate expressed in decimals. The figures refer to long-run ratios.

Financial terms of the indebtedness

To say that continual U.S. borrowing from abroad is possible in principle conveys little about its actual feasibility or its effects. Theoretically, U.S. borrowing is limited by the amount of available foreign savings; in practice, institutional and other constraints on the capacity of foreign lenders to accumulate U.S. assets almost certainly impose more stringent limitations on U.S. indebtedness. But whether continued U.S. borrowing proceeds smoothly, leads to severe financial strains, or ends in a crisis is likely to depend less on absolute institutional limits than on the *willingness* of foreigners to accumulate the debt and the effects of such willingness on financial markets. In particular, continued rapid increases in U.S. indebtedness may well put significant upward pressures on U.S. real and nominal interest rates and could add to the volatility of domestic and international financial markets.

It is reasonable to expect that the accumulation of U.S. foreign indebtedness will lead to somewhat higher U.S. real interest rates than would otherwise prevail. Generally, the real return on any given type of asset must be greater the larger its supply in relation to the market as a whole. Conceptually, this increase in the yield paid amounts to a premium for the additional risk incurred by the lender in holding more of the asset. This risk can arise from the possibility of default, unexpected changes in the asset price, or other factors affecting an instrument's value to an investor.

The risks associated with U.S. external debt, however, are significantly different from those typically associated with past debtor nations. The major risks associated with lending to most foreign countries in the past have been sovereign and related risks arising from insolvency and/or the inability of debtors to obtain the foreign exchange needed to repay creditors. Such risks are likely to be relatively small in the case of the United States, which can borrow in the major international currency, the dollar, and allows capital to flow freely across its borders. In the aggregate at least, default risk on U.S. debt is also minor for the foreseeable future; even pessimistic projections of U.S. debt service burdens are within limits successfully maintained by other countries in the past.

Instead, the primary risk to foreign holders of U.S. debt is likely to be exchange rate risk arising from unexpected changes in the dollar's value. With the United States a net debtor, a representative foreign investor will almost certainly have to maintain a net exposure to dollar assets and thus will face the risk of loss from fluctuations in the dollar's value.[14] In large

[14]Both U.S. and foreign residents face certain common risks in holding dollar assets, in particular from unanticipated inflation, which reduces the purchasing power of dollar claims. Foreigners, however, face greater losses from fluctuations in the dollar's real value (changes that do not simply offset inflation differentials) than U.S. holders. The reason is that the real depreciation reduces the dollar's value more in terms of foreign goods and services than it does in terms of U.S. goods. Dollar instruments are thus intrinsically more risky to foreign holders than to U.S. holders (the reverse is of course true of foreign currency assets).

part because of the potential size of U.S. indebtedness, this risk could become important and its effects on U.S. interest rates would be at the least persistent and very possibly quite significant in magnitude. Thus there is no reason to believe that the United States can avoid financing strains from external debt simply by borrowing in its own currency. Moreover, these strains are likely to increase as U.S. indebtedness grows in relation to foreign wealth.

Admittedly, very little information is available as to how large these effects might be. Even a modest increase in U.S. real interest rates, however, could have significant long-term impacts on the U.S. economy. Historically, U.S. real interest rates on highly rated corporate bonds have averaged between 2 and 4 percent, depending upon maturity. An increase of as much as one percentage point in this long-term average (an outcome that cannot be excluded on the basis of available evidence) could add perceptibly to the cost-of-capital faced by domestic enterprises and adversely affect domestic capital formation and the productivity advances dependent on it.[15] As noted earlier, higher U.S. real interest rates also tend to raise the effective burden of servicing U.S. external debt.

Beyond the effects on interest rates, the implications of U.S. indebtedness for this country's financial autonomy and the stability of financial markets have raised concern. Worries have been expressed, for example, about the rise in foreign ownership and controlling interest in U.S. corporations that continual borrowing from abroad may produce. Foreign direct investment in the United States is very likely to rise significantly in coming years (for reasons only partly related to our external deficit), although foreigners' controlling share in U.S. industry is likely to remain well below that held in Canada and many other industrial countries.[16]

There is also a real possibility that future growth in U.S. net indebtedness will raise volatility in domestic financial markets and increase their vulnerability to certain disturbances. The basic reason is that the risks from holding dollar assets are generally greater for foreigners than for domestic residents. The larger the net exposure incurred by foreigners in financing U.S. deficits, the greater their potential loss from an adverse change in the dollar's value. For this reason, a given disturbance, say a perceived deterioration in U.S. economic prospects, could lead to greater shifts in desired foreign (and market) holdings of dollars, and thus greater fluctuations in foreign exchange and domestic financial markets, as the share of U.S. assets held by foreigners increases. On this question also there is little evidence whether such effects are likely to be significant or not. However, the sometimes adverse market reaction to announcements of large U.S. trade deficits over the last few years at least suggests that continued rapid growth in U.S. indebtedness could add to financial volatility.

Burdens on wealth and living standards

Finally, it is often asserted that the United States will be poorer in the future as a result of the deficits and that the burden of servicing the external debt will lower future living standards. These living standard and wealth implications clearly cannot be meaningfully defined independently of the ultimate causes of the external deficit. In particular, a deficit that raises domestic investment and capital formation will generally enhance national wealth and real incomes. As we have seen, however, the present U.S. deficit is a reflection of reduced national saving from past trends rather than increased national investment; indeed, the ratio of net investment to GNP since 1982 has been the lowest of any postwar recovery.

At the least, future U.S. wealth will be impaired if the relatively low national savings rate now underlying the external deficit continues. By the mid-1990s, in fact, the national wealth of this country could be nearly $1 trillion lower — nearly $4000 per citizen — than it would have been had the savings rate remained at its pre-1980 average.

Continuation of present trends is also likely to have an adverse cumulative impact on the long-term real incomes and living standards of U.S. households. The servicing of the external debt itself will probably not be the main source of this burden, however. The debt service can largely be borrowed from abroad (without any further increase in the deficit or debt ratios to U.S. or foreign GNP). Only if the external debt raises interest rates drastically or if foreign lending is otherwise curtailed is a substantial trade surplus to meet the service payments likely to be required — a very remote possibility although one that cannot be ruled out. Real domestic spending will, of course, have to slow sharply from its past average to close the present gap with output as the trade deficit declines; at that point, spending *in relation to output* will be back on its pre-1980 trend.

Nonetheless, even if the debt is largely serviced through continued foreign borrowing, the potential for future real output growth (and hence spending) is likely

[15] See Juann Hung, Charles Pigott, and Anthony Rodrigues, "Financial Implications of the U.S. External Deficit," in this issue of the *Quarterly Review*.

[16] In book value terms, the *gross* stock of foreign direct investment claims on the United States now amounts to about 6 percent of GNP. A doubling in this ratio — probably no more than is likely over the next five years — would place it well above the ratios for Germany and Japan, about equal to the ratio for the United Kingdom, and well below the nearly 25 percent ratio for Canada.

to be seriously eroded unless present rates of private consumption and government spending are reduced significantly. As explained earlier, foreign financing of the excess of aggregate spending over output cannot continue indefinitely: its disappearance is a direct consequence of the necessary decline in the trade deficit. If private consumption and government spending were maintained at their present levels relative to output under these circumstances, the present rate of net investment eventually would be cut nearly in half, to about 3 percent of output.[17] A net investment rate of 3 percent would represent a very substantial departure from past trends; it would support little more than a 1 percent annual growth in the nation's capital stock; and increases in capital per worker, a critical source of past productivity increases, would largely cease.

Growth in future potential output and in productivity would very likely be reduced significantly, and growth in real wages and household incomes slowed considerably if not curtailed, by a decline in net investment of this magnitude. A large decline is inevitable, however, unless noninvestment spending is restrained and savings raised relative to output. Admittedly, the impact of lower investment is small in any given year and may be imperceptible at first. Its effects, however, will accumulate over time, with potentially significant adverse impacts on real earnings of workers and on living standards some years from now. This prospect is especially of concern in view of the long-term need to raise productivity and real wages to meet the needs of the growing retired proportion of the population.

Adjustments to the deficit

As we have seen, bringing the U.S. external position to a sustainable long-run equilibrium requires a substantial reduction in the trade deficit. Intrinsic to this restoration of equilibrium are two basic macroeconomic changes that must occur under any circumstances. First, domestic spending on private and public consumption and investment must fall relative to domestic output; this means that the growth of domestic demand will have to be significantly below that of real GNP for at least several years. Second, there must be an expansion of output and reallocation of resources toward manufacturing and other traded goods sectors relative to nontraded activities. These shifts will require significant changes in financial markets, in output and factor prices, and in spending patterns. The exact nature and timing of these changes will depend upon the evolution of the factors underlying the deficit and other future economic circumstances; in particular, the adjustments will be influenced by the interest rate and other financial consequences of the accumulating U.S. indebtedness. Qualitatively, the changes necessary to restore equilibrium are the opposite of those associated with the development of the deficit over the first half of this decade. This process of reversal has been underway for the last several years, but it clearly has further to go.

Three elements of this adjustment process are particularly critical and most likely to present problems. The first is the reduction in the growth of domestic spending that is the necessary counterpart of the elimination of the trade deficit. Spending now going to domestic needs — that is, some combination of government expenditure, private consumption and investment — will have to grow significantly more slowly over the next several years, particularly relative to the first half of the 1980s but also in comparison with historical averages. This reduction is, of course, necessary to correct the overspending relative to domestic production underlying the present trade deficit. Even a relatively gradual adjustment in this imbalance is likely to entail a very marked shift in past spending growth; this is particularly true since resource constraints limit future output growth to rates significantly slower than those over the past several years. For example, eliminating the present gap between spending and production (now about 3 percent of GNP) over the next five years would require that domestic demand growth fall to one-half or less of its nearly 4.5 percent annual increase over 1983-88.

Second, the adjustment process is also likely to pose problems for the authorities in reconciling domestic stabilization objectives with the necessary requirements of the external adjustment. The necessary slowing of domestic demand growth means, of course, that the U.S. economy will be more dependent upon stimulus from the external sector and, in this sense, more vulnerable to fluctuations in real growth abroad. At the same time, any significant further dollar depreciation needed for the adjustment could add to domestic inflationary pressures. In effect, therefore, the adjustment process is apt to mean a deterioration in the effective trade-offs between the maintenance of full employment, real growth, and price stability. (This again is a partial reversal of the situation facing U.S. authorities during the dollar's appreciation, which to some extent improved the trade-offs between growth and inflation.)

The third key aspect of the adjustment process involves the redistribution of national output and

[17] As interest payments rise, national income will fall relative to output. Standard consumption functions imply that consumption will vary with income and hence decline as a share of output. To the extent this occurs, the "crowding out" of investment will be reduced. However, this adjustment may well occur slowly, with the higher per capita consumption levels maintained for some time.

resources toward traded goods industries. This process will be beneficial in helping to restore the international competitiveness of U.S. industries, which was seriously damaged by the dollar appreciation and other macroeconomic forces associated with the development of the trade deficit. The changes needed to achieve this reallocation, however, may again lead to strains over the near to medium term. One concern is whether there will be sufficient capacity in U.S. manufacturing industries to meet the growing demand from the external sector. Such constraints, to the extent they now exist, are likely to ease in coming years as manufacturing industries invest in increased capacity to meet growing demand in international markets. But this process could occur more slowly than in the past because firms may well view such investments as more risky than before, given their losses from the trade balance deterioration, and hence may be more reluctant to expand capacity than in the past.

A related concern is whether the changes in relative prices needed for the reallocation of activity to traded goods sectors can occur without significant upward pressures on the aggregate price level. Attracting the resources needed to expand capacity will entail an increase in output prices and wages in manufacturing relative to nontraded goods sectors, at the same time that U.S. prices relative to those of foreign competitors must decline. Institutional impediments, such as rigidities impeding downward adjustments of prices or strong tendencies for domestic industries to match price changes by foreign competitors, may make it difficult to accomplish the needed relative price adjustments in a noninflationary environment.

All of these adjustments will be substantial, at least cumulatively, although they are unlikely to be as severe as those implied by analyses assuming a balanced current account (or a zero net indebtedness position) as the necessary endpoint. The severity of the adjustments will depend on two factors that have recently elicited much pessimism: the responsiveness of the trade balance to changes in the dollar, and the robustness of foreign real growth.

The responsiveness of the trade deficit to dollar changes depends essentially upon two conditions. The first is the response (that is, elasticity) of the demands for U.S. traded goods to changes in their prices relative to those of competing foreign products; the lower this elasticity, the larger the deterioration in the terms of trade that will be needed to reduce the deficit. The second factor is the pass-through of changes in the dollar to import prices relative to domestic counterparts: the smaller this pass-through, the greater the depreciation required to achieve a given improvement in U.S. relative to foreign traded goods prices. The lower collectively these responses are, the greater the decline in the dollar and the terms of trade that will be needed to achieve a given improvement in the (nominal) trade balance. In this sense, the adjustments needed to restore external equilibrium are likely to be more severe, and the associated trade-offs between domestic real growth and inflation less favorable, if these responses are low rather than high. Over the last several years, the responses of U.S. trade to changes in the dollar and relative prices seem to have been significantly smaller than those observed in earlier periods, although it remains unclear whether the more recent pattern reflects a lower overall response or simply a longer delay in that response. If the former, the strains resulting from the adjustment may be significantly greater in proportional terms than during past episodes of trade deficit reduction.

The robustness of foreign real growth has similar implications for the severity of the adjustments. Achieving equilibrium in the trade balance will require some combination of slower real U.S. domestic demand growth and dollar depreciation, the amounts being greater the slower the real demand growth abroad. Indeed, without adequate growth abroad it may be impossible to achieve a substantial further improvement in the U.S. trade deficit over the next several years while limiting dollar depreciation and maintaining full-employment growth in the United States. In this sense there is a potential trade-off between external adjustment and internal real growth and price stability objectives that partly depends upon foreign growth performance. It is largely for these reasons that U.S. policymakers have repeatedly emphasized the importance of this performance to the global external adjustment process.

Finally, delaying the changes needed to restore long-term equilibrium and relying primarily on automatic market forces rather than changes in U.S. fiscal policy to achieve it are quite likely to increase the severity of the adjustments and the attendant risks. Postponed adjustment will mean larger U.S. indebtedness and quite possibly higher U.S. real interest rates; if these conditions develop, the amount of trade deficit reduction needed to restore equilibrium will be greater. Largely for these reasons, delayed adjustment is likely to involve more severe reductions in real spending growth, more dollar depreciation, and a riskier financial environment. A protracted adjustment will also mean postponement of the restoration of competitive equilibrium to U.S. (and foreign) manufacturing and in this sense involves microeconomic costs as well: as we have seen, the present allocation of resources between traded and nontraded goods sectors underlying the U.S. trade deficit effectively amounts to a departure

from long-run equilibrium.

Fiscal policy will affect the severity of these adjustments in part because it will be a key determinant of the speed at which equilibrium is restored. Compared to a program of budget deficit reduction, maintaining the current status of fiscal policy is very likely to mean a substantially slower reduction in the trade deficit, a larger accumulation of indebtedness, and hence more severe financial and adjustment consequences. To illustrate with an extreme example, eliminating the U.S. trade deficit could take *a decade or more* if the present ratio of the U.S. budget deficit to GNP were to be maintained. Unchanged fiscal policy is also likely to mean that most of the resulting (larger) adjustments will fall on private consumption and investment; capital spending is thus likely to be most adversely affected in this case.[18] In contrast, lowering the deficit by reducing government spending is likely to place less burden on private spending. This does not necessarily mean that arbitrary fiscal policy measures should be undertaken simply to reduce the external deficit without regard to their other benefits and costs. These considerations do strongly suggest, as those worried by the external deficits have warned, that there are real and potentially quite costly trade-offs from simply waiting for the market to correct the deficit.

Conclusion

For most of this decade, warnings have been sounded about the adverse consequences of the U.S. external deficit, as well as the companion federal budget deficit. These warnings have focused on the potential reduction in future living standards and wealth arising from the current account deficit and, increasingly, on the risks of a crisis if the imbalance is not brought down. Given that these dire consequences for the most part have not occurred and that the U.S. economy remains apparently healthy in key respects, it is perhaps not surprising that skeptics have questioned whether the deficit is so great a problem.

The analysis in this article suggests that while the skeptics have raised some valid points, the contention that policy makers can ignore the current account imbalance without risk is incorrect. The U.S. external deficit is admittedly only the consequence of more fundamental factors causing an imbalance between national savings and investment. Moreover, restoration of equilibrium in the external accounts may not require that the current account deficit be eliminated entirely. But these are not the most important issues to be addressed in evaluating policy toward the deficit. More basic from this perspective are the nature and severity of the adjustments needed to restore equilibrium and the long-term consequences of the U.S. indebtedness.

This article has shown that there are genuine problems associated with the external deficit, some already manifest. By any standard, the lost jobs and excess capacity in the U.S. manufacturing sector during the first half of the 1980s have been important problems, with tangible costs in terms of resource reallocation and the resulting strains on the world trading environment. Other potential problems associated with the adjustment to the external deficit are also evident. The effects of the declining dollar, the response of trade flows, and the need to slow U.S. domestic demand growth while sustaining foreign growth have become major focuses of concern about macroeconomic policy here and abroad. These concerns are apt to persist and perhaps intensify since, as we have seen, balance in the trade account must be restored and will take at least the next several years, and conceivably longer, to be completed.

Of as much, and perhaps even more, concern are the longer term financial consequences of the U.S. indebtedness, in part because little is known about their likely severity. A long-term rise of significant magnitude in U.S. real interest rates along with a substantial increase in financial market vulnerability to certain disturbances certainly cannot be ruled out if large deficits continue; such outcomes could have serious consequences for the growth and productivity performance of the U.S. economy in future years. Admittedly, the possibility that the financing of the deficits will continue without significant strains or other adverse consequences cannot be ruled out either. This is not much comfort for policy makers, however, who cannot ignore prospective problems simply because their magnitude cannot be predicted with precision or certainty. What is reasonably certain is that the problems and risks that do arise from U.S. indebtedness will be persistent ones; once these problems appear, policy makers will face a choice between allowing them to continue or making substantial further protracted adjustments in the current account to bring the debt back down.

The ongoing and adjustment costs, and their likely aggravation as the deficits persist, are one set of considerations that must be weighed in deciding on policies toward the external imbalance. Policy must also be based, of course, on the other costs and benefits of specific measures to reduce the deficit. Not all actions to reduce the deficit are equally desirable, and indeed some — for example, measures that discourage investment or raise trade barriers — are likely to create more

[18] This is not to claim that lowering the budget deficit will lead to less severe adjustment regardless of the policy used. Reducing the deficit by raising taxes on investment could well have unfavorable consequences, for example.

problems than they solve. Nonetheless, the overall evidence strongly suggests that the U.S. external imbalance is primarily the result of increased private consumption and public spending arising in part from government actions. The question for policy is, therefore, whether postponing the changes needed to reduce this spending is advisable in light of the growing problems that continuing external deficits are likely to bring.

Charles Pigott