Debtor Nation

The rising risks of the American Dream, on a borrowed

by Jonathan Shaw

Consumerism is as American as cherry pie. Plasma TVs, iPods, granite countertops: you name it, we'll buy it. To finance the national pastime, Americans have been borrowing from abroad on an increasingly stunning scale. In 2006, the infusion of foreign cash required to close the gap between American incomes and consumption reached nearly 7 percent of gross domestic product (GDP), leaving the United States with a deficit in its current account (an annual measure of capital flows to and from the rest of the world) of more than $850 *billion*. In other words, the quantity of goods and services that Americans *consumed* last year in excess of what we *produced* was close to the entire annual output of Brazil. "Brazil is the tenth largest economy on the planet," points out Laura Alfaro, an associate professor of business administration who teaches a class on the current account deficit at Harvard Business School (HBS). "That is what the U.S. is eating up every year—a Brazil or a Mexico."

Whether this practice is sustainable—and if not, how it might end—are questions that divide scholars and investors alike. We have borrowed so much from abroad—between half a trillion and a trillion dollars a year for the past six or seven years—that in 2006, our investment balance with the rest of the world (what we pay foreign investors on their U.S. assets versus their payments to us on our investments abroad, historically nearly equal) tipped to became an outflow for the first time in more than 50 years. We are a debtor nation swiftly heading deeper into debt.

The global imbalances created by this dynamic of American borrowing and foreign lending appear stable for now, but if they slip suddenly, that could pose serious dangers for middle- and working-class Americans through soaring interest rates, a crash in the housing market, and sharply higher prices for anything no longer made domestically. Harvard economists and political scientists see possible threats to globalization (the opening of markets and trade that has made the economy a world phenomenon): the risk of rising protectionism; the potential for a world recession if market forces unwind the imbalances too quickly; and even the possibility that political considerations could trump shared economic interests, causing nations to use their international financial positions as weapons.

That last idea—that nations can wield power through their accumulation of currency reserves—is rooted in our own history. When President Dwight D. Eisenhower learned in 1956 that Britain, in collusion with France and Israel, had invaded Egypt without U.S. knowledge, he was infuriated. "Many people remember Suez," notes Jeffrey Frankel, Harpel professor of capital formation and growth at the Kennedy School of Government (KSG), but few recall "the specific way that Eisenhower forced the British to back down." At the time, there was a run on the pound sterling and he blocked the International Monetary Fund (IMF) from stabilizing the currency. With sterling on the verge of collapse, says Frankel, "Eisenhower told them, 'We are not going to bail out the pound unless you pull out of Suez.'" Facing bankruptcy, the British withdrew. This incident, notes Frankel, "marked the end of Great Britain's ability to conduct an independent foreign policy."

Putting international politics aside for a moment, "When a country gets a capital inflow [such as the United States has now], generally speaking things are pretty good," observes Jeffry Frieden, Stanfield professor of international peace. "It allows you to invest more than you save, and consume more than you produce. There is nothing necessarily wrong with that," he notes. Firms do it all the time, and so do households. They borrow on the expectation that they will be more productive and better able to pay the money back in the future. The United States, for example, was "the world's biggest debtor for a hundred years," Frieden notes, "but the money was used to build the railroads and the canals and the factories and to improve the ports and to build our cities. It was used productively, and it worked. The question to ask now is not, 'Is the country living beyond its means?' The question is, 'Is the money going to increase the productive capacity of the economy?' Because if it just goes to getting everybody another iPod," he warns, "then unless iPods make people more productive, there is going to be trouble down the road when the debt has to be serviced."

Trouble struck Mexico in 1995, Thailand, Malaysia, and other countries in 1997, and Argentina in 2001, after those countries borrowed vast sums in the international marketplace. Argentina before the crash had been a model developing nation and a darling of the IMF, closely following the fund's economic prescription for integration into the global system of finance and trade. But even the IMF could not save the country from the destabilizing effects of international capital flows. When global investors realized that Argentina's debt load was unsustainable,

Illustrations by Dan Page

they sold their assets, called in their loans, and exited the country. Overnight the Argentine peso plummeted in value against the dollar, the currency in which debt had been issued, and staggering obligations suddenly became unpayable. Argentines who had financed their mortgages in dollars lost their homes. There was a run on the banks, and the government imposed a limit on cash withdrawals. In a country abounding with wheatfields and cattle ranches, starving people began raiding garbage bags in wealthy neighborhoods.

Paul Blustein, a financial reporter for the *Washington Post* who wrote *And the Money Kept Rolling In (and Out)*, describes a vivid scene after the crash when a truck carrying Angus steers overturned on a highway: a crowd of machete-wielding shantytown residents slaughtered and butchered them, fighting each other for the bloody chunks of meat. He recounts stories of middle-class families riding a government-provided train into Buenos Aires each night to pick through garbage, searching for bottles, cardboard, and newspapers—anything that could be sold for recycling. This—in a country that had been prosperous, with no inflation and 6 percent annual economic growth.

Despite the differences between Argentina's borrowing and our own (especially the fact that we borrow in our own currency, eliminating exchange-rate risk), Blustein finds unsettling "the manner in which the flow of foreign capital into the United States has rendered its policymakers complacent about the nation's budget and trade deficits...." Official assurances "that foreigners will continue to provide the funding the United States needs as long as the country remains a good place to invest bear eerie similarities," he writes, "to the logic employed by Argentine policymakers."

Drowning in Liquidity?

Money flowing into the United States injects purchasing power into the economy unevenly—it affects certain sectors, such as housing, more than others. "Assume the world is divided into things that are tradable and things that are not," says Jeffry Frieden. Hard goods, clothing, and most foods are tradable: they are transported easily across borders and are therefore subject to international competition. Haircuts, housing, medical care, restaurant food, and public transportation, on the other hand, are consumed where they are produced. Because these kinds of goods and services can't be exported or imported, they are considered non-tradable. When foreigners are buying our currency, the dollar appreciates, making international goods relatively inexpensive. That leaves consumers with even more money to spend on non-tradables, such as housing and land. And because housing and land are not subject to foreign competition, their price goes up. Relative price indices from 1980 to 1985, a period characterized by large capital inflows resulting from the huge Reagan-era federal deficits, show that the price of industrial commodities, finished goods, and motor vehicles rose between 18 and 28 percent, but the price of non-tradables rose two to three times faster. "Relative price trends over the last seven years show a similar phenomenon," Frieden reports.

"It drives me crazy," he adds, "when I read in *Business Week* or the *Wall Street Journal* all the idiosyncratic reasons that people come up with to explain why the cost of housing has been going up. The reason is because the dollar has been rising" as capital has flowed into the country and kept interest rates down.

"Rising housing prices have a substantial follow-on effect," Frieden explains, "when middle-class Americans, whose principal asset is their home, realize that their wealth has increased and they can therefore increase consumption." This is not just a psychological thing, he points out. Houses increased in value, so people borrowed more, stopped saving as much, and cashed out the equity in their homes when they refinanced. When a house that cost $200,000 in 1999 swelled in value to $450,000 in 2005, lenders extended credit of up to 100 percent of the equity in that home. The sums involved are enormous. In a 2006 article in *Foreign Affairs*, Baker professor of economics Martin Feldstein wrote that "the increase in consumer spending as a result of increased wealth has been reinforced by the process of mortgage refinancing.... In the past five years, the value of U.S. home mortgage debt has increased by nearly $3 trillion. In 2004 alone, it increased by almost $1 trillion. Net mortgage borrowing not used for the purchase of new homes that year amounted to nearly $600 billion, or almost 7 percent of disposable personal income." Says Frieden, "Rising home prices have led to feelings of well-being and an expansion of consumer credit, and, therefore, consumption." So have rising equities, as people have watched their retirement portfolios double in value and concluded that they don't need to save as much.

The Loser's Perspective

But momentary feelings of well-being are not the whole story. Virtually any economist will tell you that globalization is good, but that it creates winners and losers. The benefits of global trade accrue from what economists call "comparative advantage," the theory that a country gains from specializing in production activities at which it is relatively better (even if it is not the absolute best at producing anything). All of the countries that do this are better off than they would be without international trade. But even though it is possible to prove mathematically that this is true for nations, it is not true for every group of people within nations. These, Frieden says, are globalization's losers: firms that will be driven out of business; workers whose wages will go down or whose jobs will be displaced by foreign competition; mortgage holders who will be foreclosed upon by foreigners; corporations that will be bought by foreigners and, like Chrysler, discarded. When a country runs a large current-account deficit, as the United States does now, foreign manufacturers and holders of dollar debt come into focus as their factories supply American stores and their financiers buy more iconic American assets.

Jeffrey Frankel

"Part of the reason people are spending beyond their means," says Rawi Abdelal, an associate professor of business administration at HBS, "is because they are—in a way—witnessing the end of the American dream." Between 2000 and 2005, even as the U.S. economy grew 14 percent in real terms, and worker productivity increased a remarkable 16.6 percent, workers' average hourly wages were stagnant. The median family income fell 2.9 percent.

Though these trends—which signal rising income inequality—concern economists, few people are complaining at the moment. "When money is flowing into an economy," as it is into the United States now, "people feel pretty good about the way things are going," notes Frieden. Homeowners can easily establish home-equity lines of credit that, for the time being, let them use their residences like an ATM. Some people have refinanced their mortgages three or four times to buy cars, swimming pools, and other luxuries. "It seems like we are borrowing to have a party," says Abdelal. Brazil, Mexico, Argentina, Taiwan, Korea, Indonesia—all these developing countries have gone through this stage, says Frieden, and no one really complained about the borrowing while it was happening because it was making more capital available for investment and consumption.

"But if you borrow," says Abdelal, "you have to have a theory about why it is sensible. It is not obvious that the U.S. government has a theory about why it is sensible to borrow, and I feel very nervous that the American public does not have a good theory about why they are borrowing so much money, either. We are not taking all this money and investing it."

Less than 30 years ago, the interest rate on home mortgages ran to 13 percent or more. Inflation was in the double digits, and the prime rate that credit cards use to set interest charges rose above 15 percent. If that happened again, investment would plummet and there could be huge social costs. Says Frieden, "It is one thing to say there was a big decline in the price of mansions in Silicon Valley, but if a million middle- and working-class families are forced out of their homes, that is a real social cost. What will happen to our relationship with the rest of the world when the constraints start to bind?" he asks. "What will happen when they go from allowing us to run these deficits to forcing us to tighten our belts?"

A resurgence of protectionism is one concern. Says Abdelal, "I think the public's view has been turning away from the idea that we actually benefit from these cheap Chinese imports. Of course, economists always say, 'Look, we can do the cost-benefit analysis and when you buy your cheap stuff at Wal-Mart, that is good for [American consumers]'.... So we can talk about 'comparative advantage,' but what is important…is whether or not the commitment to open markets is politically sustainable." He sees warning signs that it may not be: "drumbeating about China"; "the rising riskiness of middle-class life in the United States, for which people, rightly or wrongly, blame the globalization of goods markets"; the debate about how big the wall should be between the United States and Mexico, not whether we should have one; the Dubai ports episode; the scuttling of a Chinese company's offer to buy American oil company Unocal. "Here we are with the

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Photographs by Stu Rosner

“The real danger is that the current account might change very rapidly.”

biggest current account deficit ever—we require foreign capital—but if it is Arab or Chinese foreign capital going into a sector that we might be worried about, we tell them, ‘No, no, no, we only want you to buy Treasuries.’ What would happen to the American commitment to openness,” Abdelal wonders, “if we had a real recession or a real crisis?”

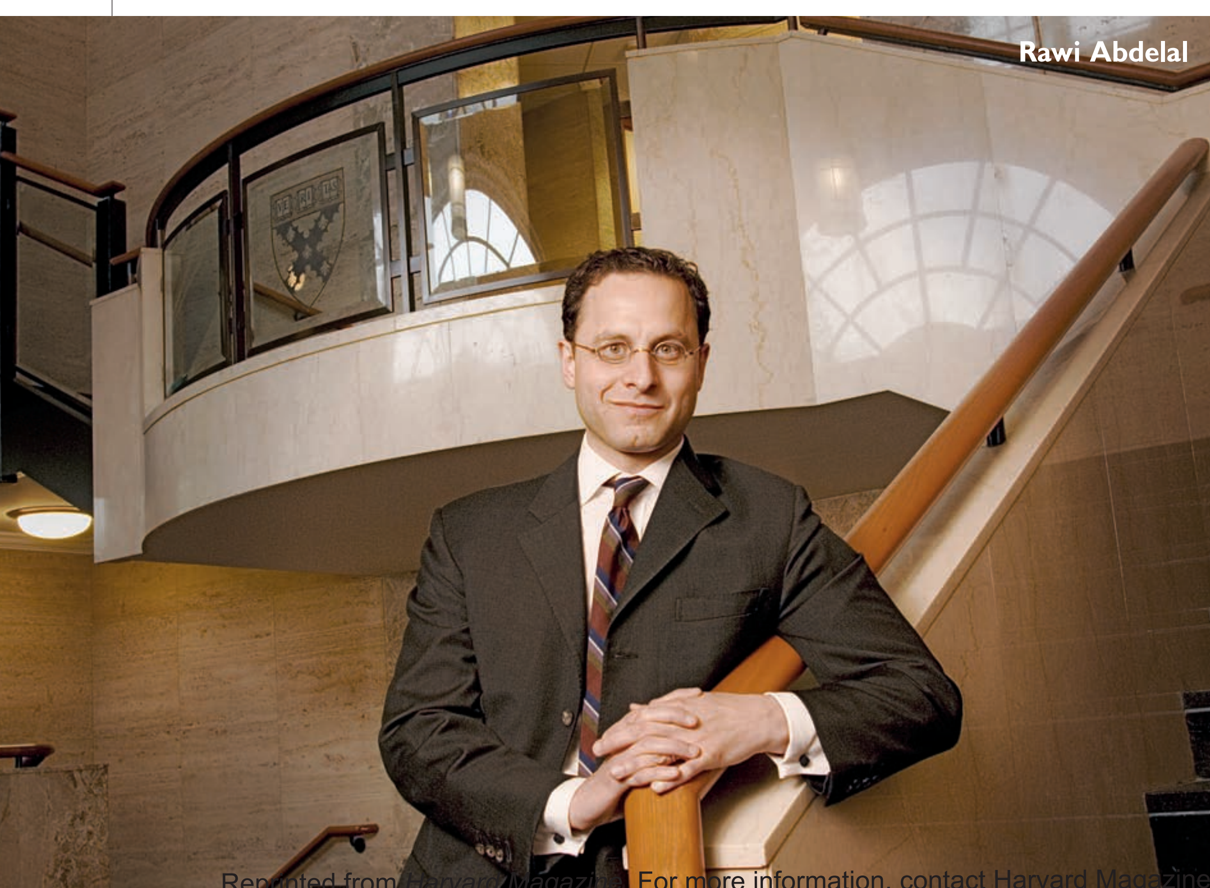
Absent protection for globalization’s losers, history suggests that they will become the core of opposition movements. “There is a commonality to their demands,” Frieden says. “They typically argue in favor of protecting [those] people who are doing poorly in international competition from the ravages of the global economy.” Pat Buchanan is an American example of a convinced protectionist. “He says, ‘Let’s protect the workers in North Carolina and farmers in Kansas and to hell with Wall Street and Silicon Valley,’” says Frieden—“a very popular message outside Wall Street and Silicon Valley.” Sometimes we do protect the losers: price supports for domestically produced sugar cause Americans to pay two to three times the world market price. Without the supports, Americans as a whole might be better off, but “several thousand sugar producers and maybe a hundred thousand farm workers would go out of business. Even if we could all agree that globalization is good for the economy as a whole and good for the majority of Americans,” says Frieden, “there will still be a non-trivial minority for whom it is not good.” He wonders, “Is any political system up to the task of compensating losers in order to generate benefits for society as a whole?”

Protectionism is a legitimate concern stemming from global financial imbalances, agrees the Kennedy School’s Jeffrey Frankel. “That is what happened in 1971 and 1985 when Americans became worried about trade deficits that were indeed alarming, but drew some incorrect conclusions. We economists always explain that the deficit is the result of macroeconomic forces, and that we need to cut the federal budget and depreciate the dollar, but to your average congressman and your average man in the street, that doesn’t seem very tangible. There is a temptation for scapegoating,” he explains. “It was Japan in the 1980s and now it is China and, on outsourcing, India.” Adds former U.S. Treasury Secretary Lawrence H. Summers, the Eliot University Professor, “I think there are enormous potential losses—in terms of consumer well-being and the real incomes of workers, and ultimately, in terms of the ability to maintain a stable global system—that come from the threat of protectionism, and so I think containing that threat is enormously important.”

The Foreign Dimension

Our own openness to international flows of goods and capital is only half the equation. On the other side of American borrowing is lending by foreign agencies, banks, and governments, which continue to accumulate massive reserves of U.S. currency, frequently in the form of low-yielding government bonds. (China holds more than $1 trillion in currency reserves, mostly denominated in dollars; Japan is a close second.) This flow of funds from emerging economies to the developed world (the United Kingdom and Australia run current account deficits, too) is a startling reversal of the usual pattern, in which developed nations have loaned money through institutions such as the IMF and the World Bank to emerging economies that need investment in their own nascent growth. Furthermore, as Summers points out, the real returns on these reserve investments, measured in those countries’ local currency and after adjusting for inflation, are close to zero. Why these countries are sending us their money—while choosing investments with returns so low that they could easily turn negative if the dollar were to depreciate significantly—is, he says, “a very profound question, in my judgment.”

How these lenders to the industrialized world decide to act in the future has large implications for whether the imbalances sort out gradually or violently. Although their desire to lend and export is aligned for the moment with our consumerism, we cannot expect that they will want to keep



Rawi Abdelal

accumulating dollar-denominated debt forever.

The "rational reason" for reserve accumulation by countries like China, says Kenneth Rogoff, Cabot professor of public policy and professor of economics at the KSG, "is that they are terrified of having a financial crisis and, by stocking up on Treasury bills, the government puts itself in a position to bail out banks and bail out companies in an emergency." Free trade may be good, but financial-market liberalization can be destabilizing, because it exposes small economies to massive flows of capital, measured in billions of dollars daily, that crisscross the globe at the speed of light. These flows are the sum of the actions of investors worldwide, and can subject countries to the capricious swings of free markets. If investors lose confidence in Thai investments, for example, and all pull their money from the country at once, their sudden withdrawals can precipitate a collapse of the currency, followed by dire effects on citizens' standard of living. This is what happened during the Asian financial crisis of 1997 to 1998. After a series of emerging-market meltdowns, says Abdelal, accumulation of reserves has become the way developing countries can "self-insure against a crisis—a kind of national insurance within the international system," without the loss of face and autonomy associated with a bailout by the IMF.

But the argument that countries such as China want to avoid a crisis probably explains only "the first couple hundred billion" of reserve accumulation, says Rogoff. "What they are doing now goes far beyond that—and has a corrupting aspect, because if banks and state-owned firms *know* they are going to get bailed out, they keep doing the same things they were doing to get in trouble in the first place."

Summers believes that the reserve accumulation going on now "is, in significant part, because they want to maintain an export-led growth strategy." In 1999, he observed that the global economy depended on the U.S. economy (which accounts for almost 30 percent of global economic output, and an even higher proportion of final demand), and that the U.S. economy depended on American consumers (whose consumption is equivalent to 70 percent of GDP). Consumption had become what Summers has called the "single American engine" propelling the world economy. In such an environment, keeping exports inexpensive has been a rewarding strategy among our trading partners for maintaining their economic growth. China's purchases of dollars keep that country's currency weak relative to ours, making Chinese goods inexpensive for American consumers. "The reserves are not objectives in and of themselves," Summers says. "They are a means to maintaining an exchange rate at which their exports will be extremely competitive, and so are a kind of subsidy to domestic industry."

"What the Chinese have been doing works, they feel," says Rogoff—and it does work "for the one-third of people who live on the coast…[even though it] has worked a lot less well for everybody else in China. If you go into rural China, there are 150 million people who are effectively unemployed. Large sections of the rural population live in something most of us would call poverty."

The reserve policies of China and other developing East Asian nations "are very costly," notes HBS's Laura Alfaro. "When we talk about this in class, our students say, 'This is an economy growing at 10 percent a year. It is impossible not to come up with projects [for domestic investment] that will generate greater returns—even just 1 percent higher—than the U.S. Treasury interest rate." But even though in principle there are a lot of good, productive investments there, Rogoff says, much social and institutional change needs to take place to make rural China look like the coast.

Instead of increasing domestic investment to better balance the world economy, the Asian economies should concentrate on fostering domestic consumption, Rogoff believes. "Consider the fact that in China they invest more than 40 percent of GDP. That means they are not consuming it, so their standard of living could be much higher. This is very much a political-economy problem, because the elites enjoy a perfectly fine standard of living," he says. In broad terms, "The Asian currencies need to appreciate, and the Asian economies need to become less dependent on export-driven growth by cultivating domestic demand, which means raising living standards in these countries."

Developing countries are not the only ones accumulating re-

Jeffry Frieden

serves. Oil exporters are buying Treasuries for a different reason: they are "raking money in hand over fist with the sky-high oil prices, and are having trouble spending it as fast as they are earning it," Rogoff says. "Mind you, these are countries which are very poor, and in many of them there are a very small number of very rich people who don't know what to do with the money. Saudi Arabia is one example, where even with today's oil prices, average per-capita income is only $7,000 to $8,000—and even that is misleading because the royal family controls about half of the total income. So people are hardly rich there, and if it was a democracy, I don't think they would have any trouble figuring out how to spend the money." Rogoff suggests that they "need to strengthen their education systems, social-safety nets, and invest in the core of lower-income [people], where there is a huge scope for greater expenditures. Whether the elites will approve of that, I can't say, but that would certainly help reduce risk from current global account imbalances."

The causes of the U.S. current account deficit, in other words, extend well beyond the sphere of our own national control. Because they are rooted in a system that is international in scope, solving the problem without sacrificing global growth will require international cooperation.

The Contrarian

But what if our current account deficit is a side effect of globalization that is *not* going to go away? Richard Cooper, Boas professor of international economics, takes a much more relaxed view about this possibility than his colleagues do. In theory, he says, the deficit could persist forever, as long as it eventually stops increasing as a percent of the U.S. GDP.

Cooper, who was undersecretary of state for economic affairs from 1977 to 1981, and chair of the Federal Reserve Bank of Boston from 1990 to 1992, sees global imbalances as a natural consequence of a decline in investment "home bias." "What do we mean by globalization?" he asks. "What we mean is that everyone around the world thinks beyond [his or her own] national boundaries when it comes to allocating their savings." Americans used to invest almost 100 percent in the United States, but now allocate a portion of their portfolios abroad. "That is a process that is going on worldwide: foreigners are investing more abroad, too, but foreigners save more than Americans do." Because the United States is 30 percent of the world economy, a world with no home bias would see foreigners investing 30 percent of their savings in the United States and Americans investing 70 percent of their savings outside the country. "If you apply those two numbers to actual savings levels," Cooper says, "you get a $1.1 trillion current account deficit in the year 2005, with foreigners investing $2.3 trillion in the U.S. on savings of over $8 trillion, and Americans investing $1.2 trillion abroad. The difference between those two is $1.2 trillion." International diversification of investments, in other words, causes the current account gap.

"Of course we are not there yet," Cooper notes. "Actual foreign investment was about $1.2 trillion in 2005, and U.S. investment abroad was less than half that. That means that in getting from here to there—what economists call the stable state—the deficit could actually grow as a share of GDP," he explains. "It can't grow forever as a share of GDP, but it could grow for a while, as it has been doing in the last decade." How high could it go? Rogoff says that, at least in an accounting sense, we could handle deficits "until the debt level gets as high as 100 percent of GDP without breaking a sweat at today's interest rates." For his part, Cooper believes that the deficit will eventually stabilize at an absolute level, and that as long as the American economy continues to grow, the deficit will slowly decline as a percentage of GDP.

Larger deficits over the medium term may arise as a consequence of what Cooper calls "a demographic revolution." Pension funds in countries such as Japan and Germany (the second- and third-largest economies in the world) are purchasing large quantities of U.S. securities because their populations are aging more rapidly than that of the United States. Everywhere, he points out, people are living longer, but in many developed countries they are also having fewer babies. "There has been a lot of discussion in the U.S. about how we are going to finance social programs, but our problems are trivial compared with the European countries and Japan," Cooper argues. "The U.S. is a big demographic outlier.

All the other rich countries, and all of the East Asian countries, have had a crash in the total fertility rate."

"For a society just to reproduce itself, the number of children per couple has to be slightly above two, to allow for infant and child mortality," Cooper notes. By this measure, the United States is roughly reproducing itself, he says, but "in Spain, Italy, Japan, and Russia, the number is around 1.2, way below the reproduction rate, and in the other rich countries it is somewhere in between." In addition, the United States has about a million immigrants arriving each year (more, if illegal migrants are included). Consequently, 20- and 50-year projections find the U.S. population and labor force continuing to grow. "All these other countries are expected to peak and decline," he says. "Japan actually peaked in 2005, and Germany peaked last year."

We have no experience managing economies where the number of young adults is actually declining, he adds (the singular phenomenon of World War I excepted), so "We will all learn from the Japanese and the Germans, who are leading the way. They will experience less new household formation, less demand for housing, less demand for equipping new members of the labor force, less demand for schools and other public services, and more demand for healthcare." Faced with less investment required for population growth, and aware that they won't have as large a workforce to support their growing numbers of retirees, these peoples are deliberately saving a lot of money.

"If I'm running a pension fund or a life-insurance company representing an aging population, where would I put my investments?" Cooper asks. "I want good yields and I want high security." Emerging markets offer the best returns, but financial shocks in Russia, Argentina, and other countries have "taught us that foreign investments are very risky." In the United States, by contrast, "property rights are secure, and the dispute settlement system is reasonably fair and efficient, so it looks like a good place to put your money. Put those two arguments, globalization and demographic changes, together and it means that the U.S. is just a very attractive place to invest. Looking ahead, it is a more vigorous economy than those of the other rich countries."

Thus, Cooper argues, the main cause of the current account deficit is foreign investment in the United States. "Conceptually, the current account is just the negative of net foreign investment in the United States," he points out. Furthermore, "There is all the difference in the world between" this recycling of dollars and "the government of Brazil or Argentina going out and borrowing in the world interbank or capital market." For one thing, U.S. debt is in our own currency, he says. "When Argentina and Brazil borrow in London, they typically borrow in dollars, yen, or euros, so they are exposed to currency risk if exchange rates shift." That is what sank Argentina in 2001. Although magnitudes of debt are not unimportant, he adds, the structure of the debt is more important in assessing viability.

Most of our debt is also long-term, Cooper says, and therefore manageable in a growing economy. And "although central banks buy a lot of short-term Treasuries, the truth is that, on the scale they require, they have no place else to go."

Cooper doubts that eliminating the U.S. current account deficit is even possible, because in order to do so, other countries would have to move in the opposite direction, sustaining a huge decline in their current account surpluses. "The world is a closed economy," he points out, "so if we go from a huge deficit to zero, somebody has to be on the other side to the tune of the whole $850 billion. Who is it going to be? It has got to be the big economies: China, Germany, Japan, and others." Because these economies are internally less flexible than the United States, and are "export dependent," their people and leaders won't stand for it, he says, and will adopt policies that prevent it from happening.

Living with the "Financial Balance of Terror"

Although Cooper's arguments have impressed his colleagues, they don't share his relaxed view. If he is correct that the current account deficit is primarily a consequence of investment, what would happen, they wonder, if world investors changed their minds about parking their capital in U.S. government debt or mortgage-backed securities? Former Treasury Secretary Summers thinks the weakness of the "diversification finance" argument is that "it relies a lot on psychology of the kind that could prove to be quite fragile. The U.S. is borrowing at a rate

Laura Alfaro

that is unsustainable," he says. "The question is whether the adjustment will be a gradual one, in which case it is not likely to be terribly disruptive, or will be a sudden one. If there was a sudden interruption, that would complicate the system of economic management in the United States and around the world"—in ways that might be far less benign than Summers's language suggests.

Kenneth Rogoff agrees: "The real danger is that the current account might change very rapidly." The United States would have a harder time adjusting than did other countries cut off by foreign lending in the past, he says, because its exports are a smaller percentage of GDP. Instead of having to increase exports 10 percent to make up for the lost flow of capital, for example, exports might need to increase twice as much, implying a hefty depreciation of the dollar. Rogoff has estimated that in a sudden adjustment, the dollar might lose as much as 40 percent of its value compared to 2005 levels, with the result that "the dollar would fall like a rock and interest rates would skyrocket."

The price of imported goods would go up almost overnight, as happened to Mexico within a few months in 1994. Gasoline, food, foreign parts for cars, tools, toys, and television sets would cost so much more that it would put an enormous strain on middle- and lower-income Americans. And even though the United States has a robust financial system, a hard landing would mean reduced economic activity. This, says Summers, "would in turn reduce confidence, lead to larger budget deficits, lead to more pressure on interest rates, and so there are a variety of vicious cycles that could kick in." In such a situation, the Federal Reserve Board would face "a difficult dilemma," he continues, "because on the one hand you want to provide liquidity [by reducing interest rates] at a moment when foreigners are withdrawing assets, and on the other hand you want to strengthen the currency and strengthen credibility [by raising rates], and you can't both ease and tighten with one policy instrument." Nor could the federal government easily help, given that it is already running annual budget deficits of about $270 billion and facing increasing interest costs ($406 billion in 2006) to service the national debt of $8.8 trillion—$2 trillion of it held by foreigners.

A dollar crisis for the United States would be in nobody's interests, of course. If the currency dropped 40 percent, nations holding dollar reserves would see the value of their holdings drop by a like amount. Doing anything that might precipitate a dollar crisis, including suspending purchases of dollar debt, would therefore hurt everyone. (Summers refers to this as a "financial balance of terror.") But that is not enough to guarantee that such a thing might not happen, either by accident or as the result of a diplomatic crisis, says the Business School's Rawi Abdelal. "World politics is about countries doing things that are not in their narrow economic interests, but that serve some political agenda," whether a crisis like Suez, or the long-term maintenance of export-related jobs.

"The nightmare scenario," says Mohamed El-Erian, who as chief executive officer and president of Harvard Management Company (HMC) oversees the investment of Harvard's $30-billion endowment, "includes the possibility, for example, that Taiwan does something to upset China; the U.S. allies itself fully with Taiwan; and you have a political crisis with economic implications." A conflict over the Taiwan Strait, agrees Abdelal, "could lead China to diversify quickly out of dollars. I think that things could turn out very badly, very quickly."

The most important domestic remedy, says Jeffrey Frankel, who served as a member of the Council of Economic Advisers under President Bill Clinton, and on its staff under Martin Feldstein during the Reagan ad- *(please turn to page 87)*

Not Your Daddy's Deficit

In the Reagan era, the federal government ran budget deficits almost as big as the current account deficit is today—at their peak, on the order of 6 percent of GDP. At the time, economists worried that government borrowing would suck up most of the funds available for investment in domestic productive capacity—the engine of future economic growth. The concept was called "crowding out," and in a closed economy, that is exactly what would have happened: government borrowing would have crowded private borrowers out of the lending market. But that didn't happen to the extent expected. Instead, the United States began running current account deficits of 2 or 3 percent as capital flowed in from abroad. "The positive side of financial integration and globalization of capital markets," says Jeffry Frieden, Stanfield professor of international peace, "is that it makes it possible for governments, private firms, and individuals to borrow from anywhere. Mortgage holders in Belgium can finance their mortgages in Germany, Japan, or the United States. A Belgian mortgage broker could then sell those mortgages on the global financial markets. And they do." The pool of capital available to governments and individual borrowers has expanded dramatically with financial globalization.

Federal deficits thus contribute to current account deficits, but not on a one-to-one basis. "The spillover effect might be 50 percent or less," explains Benjamin Friedman, Maier professor of political economy and author of *Day of Reckoning*, a 1988 analysis of the consequences of President Reagan's economic policy. Back then, "If the government deficit was 4 percent of the national income, and the foreign deficit was about 2 percent of the national income, eliminating the government deficit would have balanced the foreign account also. These days, the federal deficit is on the order of 2 percent of GDP or less," he notes, "while the current account deficit is something like 6.5 percent of GDP." Private borrowing, rather than federal borrowing, explains most of the current account deficit today. "Narrowing the government deficit by 2 percent might therefore cause the current account to go down by just 1 percent," to 5.5 percent of GDP.

This does not mean we should ignore the federal deficit, Friedman says. Cyclical deficits to stimulate the economy when unemployment is high are fine, but we are at a high point in the business cycle: "We are at full employment, maybe more than full employment." Furthermore, he notes, we have large liabilities ahead of us associated with an aging workforce, due not so much to Social Security as to the rising healthcare costs covered by Medicare. "There is absolutely no excuse to be running a government deficit of even 2 percent in the federal account, as we are doing now, when we are at full employment and the retirement of the baby-boom generation is right around the corner," he charges. "That is irresponsible." Even so, he emphasizes, eliminating the government deficit "is not going to solve the current account problems."

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ministration, is to try to raise the national savings rate, in order to reduce our need to borrow from abroad. The difficulty is that the biggest single driver is a decline in private savings. Households that used to be saving about 10 percent of their income as recently as two decades ago are now saving nothing. But, says Richard Cooper, "We don't know how to make Americans save more." Summers allows that, "While, arithmetically, a great deal is explained by the changes in private savings, we have much more effective policy methods for changing public saving than we do for changing private savings." That means running a federal budget surplus, either by raising taxes or cutting spending. This is the one remedy on which virtually everyone agrees. But national policy cannot provide a complete solution (see "Not Your Daddy's Deficit," page 48) to a problem that is global in nature.

If the current account deficit can be managed, that will occur only as the result of international collaboration—but there is little immediate incentive for any country to move. Notes El-Erian, "It is the classic 'prisoner's dilemma.' Whoever moves first [in adjusting exchange rates upward, for example], without assurances that others will also move, could be worse off. The good outcome requires collaboration, but we don't have adequate mechanisms for that right now." For El-Erian, the problem is not hypothetical: he and his HMC colleagues want to take advantage of investment opportunities in what he calls "a global growth handoff," but they must think carefully about how best to hedge against the risk that a market accident or a policy mistake could unwind the imbalances chaotically.

In a class El-Erian taught at the business school, he worked with his students to construct investment portfolios based on two different scenarios: portfolio A, which assumes the global imbalances are sustainable, and portfolio B, which assumes they are not. "Then we said, 'In a world where the imbalances are sustainable, the first portfolio returns in the 20 to 30 percent range, while the second portfolio returns in the 2 to 3 percent range because it is very defensive. But in a world where the imbalances are not sustainable, in portfolio A you lose a lot of capital, and in B you don't.'" Which do you choose? "The problem is that there are not enough facts right now for you to have sufficient conviction about what will happen," El-Erian continues, "so you have to be open to the possibility of incorporating more information as you go forward. So we position ourselves to explicitly allow for different states of the world to play out. The reality is that we think there are arguments for both. So we try to benefit from what we do know and manage the risks of what we don't know."

Frankel says the current situation is frequently compared to the Bretton Woods system as it worked in the 1960s. "There were constant meetings then among the U.S., the Europeans, and Japan where everybody agreed not to sell dollars. They realized, 'If any one of us sells dollars, we are going to bring the whole thing tumbling down.'" That worked for a time. But back then, Frankel says, the European central bankers "met with each other every other month and looked each other in the eye and agreed not to sell. Today, there is no agreement at all. The Asian countries and the oil exporters don't meet each other regularly, they are not political allies, and there is no sense of propping up the system. The Chinese and the Japanese, the two biggest holders, are kind of at odds. And then you throw in Saudi Arabia and a whole diversity of countries that have nothing in particular in common, and you could argue that, even if they all got together and came to an agreement not to sell dollars, there would still be a huge temptation at some point to defect. But," he adds, "they are not even *trying* to agree. That says to me that at some point, somebody is going to start selling. Ideally, we would negotiate a coordinated policy package, but at the moment, in practical terms, that is," says Frankel, "unthinkable."

Alfaro, who is originally from Costa Rica, has a distinctly personal perspective on the ramifications of the imbalances. Although she remains optimistic that they can be corrected slowly, "It is the impact in the rest of the world that worries me," she says. "The U.S. hasn't had a real recession for a while." In a contraction, "There would be bankruptcies. Some Americans would lose their houses, and many people would have to adjust their standard of living. But the U.S. will still be the richest country on earth. But for the rest of the world, a 1 or 2 or 3 percent recession in the U.S. would be a catastrophe. That is the part of the U.S. role in this that I think is really irresponsible—the failure of leadership in the world."

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Richard Cooper