The State of the Debate

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This report reviews the debate between the pessimists and the optimists about the dollar and the financing of the U.S. trade and current account deficits and concludes with a discussion of our most likely case. There is a large debate between the pessimists, who argue for the "imbalance thesis" that the persistent rise in U.S. external debt owed to foreign creditors is inherently unsustainable and will trigger a dollar crisis, and the optimists, who argue for the "Bretton Woods Two thesis" that the foreign financing of U.S. current account deficits is sustainable in the long run.

The dollar bear case is based on the long-term unsustainability of an expected buildup of U.S. external debt. We do believe that the persistence of high current account deficits for many years into the future is likely to result in rising U.S. external debt over the next five to ten years. Even if this proves correct, however, it offers little insight into the trend of the dollar and the sustainability of financing over the next one or two quarters, or even over the next year or two.

The Pessimists' Case

The chain of logic in the pessimists' case is that (1) the U.S. trade deficit is excessive and will be hard to reduce without a decline in the dollar, (2) dollar weakness is inefficient in reducing the U.S. external deficits, so the size of future dollar declines will be very large, (3) major countries will be slow to move to a better-balanced mix of policies, so imbalances will be corrected instead by a market-driven dollar decline, (4) the current account deficit will be even harder to reduce than the trade deficit as the interest costs of rising U.S. external debt increase, (5) annual current account deficits will help generate a huge multiyear increase in U.S. external debt, (6) foreign investors — both private and public — will eventually become reluctant to finance the external deficit of the U.S., and (7) the dollar will decline sharply and real interest rates will rise substantially, triggering weakness in the U.S. economy, especially in the consumption and housing sectors.

The Optimists' Case

The optimists tend to start their argument not with the trade deficit but rather with the attractiveness of U.S. financial and real assets as investments. The chain of logic of the optimists is that rising U.S. external deficits should prove sustainable because of high savings rates abroad and the superior long-term investment appeal to foreign and U.S. investors of U.S. assets due to political stability, superior productivity growth, relatively favorable demographics, free markets for capital and labor and investment-friendly tax and regulatory policies.

The main argument of the optimists is not that the trade deficit is easy to reduce or that past dollar weakness will be that effective in reducing the trade deficit or that positive policy changes are likely to occur. Rather, their main argument is that high trade and current account deficits may be financed relatively easily. If so, a very gradual improvement in the trade deficit over many years can contribute to a slow orderly reduction in the external financial deficit as a share of GDP so there never needs to be a major financing problem. They also believe that the current account deficit as a share of GDP does not need to be reduced that much because high productivity growth in the U.S. justifies high investment with dollars borrowed from abroad and because the high savings rates abroad should persist, notably in Asia. If so, continued financing of the current account deficit from foreign investors anxious to accumulate dollar assets should be relatively orderly.

Our Case

What is our view? We agree in part with the pessimists and in part with the optimists. We believe that the pessimists are right that (1) the trade deficit will be hard to reduce, (2) dollar weakness is inefficient in reducing the deficit, (3) governments will be slow to reform their policy mix, (4) the current account deficit will be hard to reduce and (5) there will be a large multiyear rise in external debt. We suspect that they are probably correct in arguing that one of the developments that will contribute to a reduction in the external deficits will be an eventual further

decline in the dollar, especially against the currencies of the Asian countries that run large current account surpluses. However, we lack their conviction about the inevitability of a disorderly dollar decline. Where we agree with the optimists is that the current account deficit can be financed in the near-term and that any future dollar downtrend is likely to be relatively orderly. The external deficit is not the only determinant of the dollar. The appeal of investing in a major capitalist country with investment-friendly policies should not be underestimated. We agree with the optimists that relative demographics support the view that a balance of current account surpluses in Asia and current account deficits in the U.S. can persist for a number of years.

Persistent Trade Deficit

The U.S. has run a large and rising trade deficit for many years. In part that reflects rapid economic growth in the U.S. while European and Japanese growth has been laggard. In addition, U.S. policy supports consumption growth while policies in Europe, Japan, China and other Asian countries support export growth.

The relative size of U.S. exports and U.S. imports ensures that the U.S. trade deficit will remain high for many years. In the fourth quarter of 2004, U.S. imports in the GDP accounts ran at a $1.9 trillion annual rate (almost 16% of U.S. GDP) while U.S. exports ran at about a $1.2 trillion rate (about 10% of GDP), a difference of $675 billion in a GDP of about $12 trillion. Exports must grow much faster than imports just to keep the trade deficit from deteriorating further. After all, a 10% growth in imports is almost $190 billion and a 10% growth in exports is about $120 billion. U.S. exports should begin to grow faster than imports in the coming quarters, but that should generate only a modest downtrend in the trade deficit at best.

Limited Impact of the Weak Dollar on Trade Deficit

For a variety of reasons, a weak dollar is relatively inefficient in generating a major improvement in the trade and current account deficit in the U.S. A major cause of the trade deficit is the persistently faster growth in domestic demand in the U.S. than in other advanced economies. A declining dollar does little to correct that. In fact, the greater weakness of the dollar against industrial countries than against emerging countries has supported U.S. growth since it has stimulated exports without discouraging U.S. consumption. The export dollar has dropped much more than the import dollar.

There has been little dollar weakness against the countries from which the U.S. sources its consumer goods imports. Thus there has not been any significant rise in the price of imported consumer goods from Asia, which might slow the growth of import demand. In the last 12 months, the price of imports from China has actually dropped slightly. This helps limit the cyclical rise in U.S. inflation, but does nothing to slow the growth of U.S. imports.

The export outlook is somewhat better. The dollar has dropped sharply against the currencies of export-competing countries, including Japan and the European countries. We believe that U.S. exports have begun a sustainable trend of improvement.

The relatively low share of foreign trade in U.S. real GDP also limits the impact of the weak dollar on the trade balance. With U.S. exports near 10% of GDP, they would need to rise about 50% to close a 5% trade gap by themselves. If U.S. exports were near 30% of GDP, they would need to rise only one-third as much to close a 5% trade gap.

Another reason why the weak dollar is inefficient in correcting the trade deficit is the difference among countries in the propensity to increase their imports or exports when their economy grows rapidly. A strong U.S. economy results in a strong increase in imports, especially consumer goods imports, but this is less true in many other countries. This thesis is sometimes called "elasticity pessimism," referring to the different responses of U.S. and foreign exports and imports to growth in the domestic economy.

Policy Pessimism

There are macroeconomic policy changes in each of the major economic regions that could contribute to a lower U.S. trade deficit via weaker imports or stronger exports. If foreign domestic demand were stimulated by pro-growth reforms in Europe and Japan or Asian currencies were revalued, that would help. However, the pace of change has been glacial. There are some proposed shifts in U.S. policy that might moderate the growth rate of consumption and imports relative to the U.S. economy. Higher interest rates are a move in this direction. However, a major tightening of fiscal policy appears unlikely. **Overall, it is unlikely that large enough policy changes will occur here and abroad to significantly reduce the U.S. trade and current account deficits.**

Persistent Current Account Deficit

The outlook for a major reduction in the current account deficit is even more challenging than it is for the trade deficit. Each year's external deficit generates a permanent increase in the size of the net external debt and thus in the annual financing cost for U.S. external debt. Because the U.S. has higher returns on its external assets than it pays on its external debt, it starts with a negligible net cost for its net external

debt at the current time. However, external interest expense should now begin to grow annually as the amount of external debt rises. Higher interest rates would accelerate that rise in interest expense. The U.S. external balance sheet is analogous to a AAA-rated company on a path to BBB in five years and junk status in ten or fifteen years if the size of annual deficits is not reduced. The problem is not severe now but could eventually become so if not corrected.

Persistent Rise In External Debt

The net external debt of the U.S. has risen to about one-quarter of U.S. GDP. Historically, there are a number of instances when countries have had problems when that ratio rises above 50%. In the U.S. today, however, there are several mitigating factors.

First, many of the problems that have been faced by other countries with high net external debt were exacerbated by the fact that they had borrowed in foreign currencies and the burden of that debt increased when their own currencies declined. In contrast, dollar weakness leads to higher dollar valuations on U.S. external assets (foreign stocks, bonds and corporate subsidiaries) without much rise in the valuation of U.S. liabilities to foreigners. The explanation is that the U.S. borrows in dollars, so that valuation losses from dollar depreciation are borne not by Americans but by foreigners. Given this difference, historical comparisons with other countries with high external debt may provide limited insight into the U.S. situation today. Second, the U.S. external debt ratio is nowhere near a critical level and is unlikely to reach such a level for a number of years.

Overall, it is important to understand that the U.S. external debt problem is not a crisis today but rather a potential problem of excess debt ratios and interest service burdens that could occur five to ten years in the future if external deficits are not reduced.

Financing the External Deficit

The U.S. current account deficit is financed by a combination of private investors and public investors such as central banks. Because their financing of the U.S. current account deficit is not motivated primarily by financial returns, foreign central banks may try to concentrate any diversification out of dollars to periods when the dollar is stable or rallying, thus limiting any negative spillover effect on their own exports.

We believe that the eventual resumption of the dollar downturn against the major financial currencies is more likely to result from a shift in private sector investment sentiment than in central bank behavior. It is most likely to occur in the event of a transition from strong U.S. economic performance to disappointing economic performance in the U.S. There is little sign of that yet. However, there is a risk of a slower pace of economic expansion in 2006 in a lagged response to high oil prices and monetary restraint. Our most likely case is for an extended dollar stabilization against major financial currencies during the period of U.S. economic strength, followed by the resumption of an orderly dollar downtrend by late 2005 or 2006. Ironically, that would mean that the dollar may stabilize during the period of the highest trade deficits when growth is strong and then resume its decline when an economic slowdown weakens consumer imports and the trade deficit begins to decline.

Relative Demographics and Relative Savings

The optimists argue that orderly financial flows from countries with high savings rates will continue to provide financing to a savings-short U.S. economy. Countries that have a high proportion of their workforce in their peak working years often tend to have a high savings rate as workers save for their future retirement. The combination of high savings rates abroad and low savings rates in the U.S. generates both current account surpluses abroad and current account deficits in the U.S. Can U.S. external borrowing be financed on a sustainable basis? It depends in part upon whether foreign savings stay high relative to their own investment.

There has been widespread comment on the aging of America relative to its own past age structure. Viewed from an international perspective, however, the U.S. is a major relative winner demographically since many other countries are already aging more rapidly (Japan and Europe) and some will do so in the future (China). The birth rate has dropped less in the U.S. than in many other industrial countries and the U.S. capacity to effectively absorb demographically-favorable immigration is much greater than it is in Europe or Japan. **The aging of America argues that the U.S. needs to save, but the argument for a high savings rate is even stronger for foreign countries that will be aging more rapidly.** Due in part to relatively better U.S. demographics, long-term economic growth in the U.S. is likely to exceed the pace of its major industrial competitors. The countries of the three major financial currencies (dollar, euro, yen) all share a stable political system and respect for contract law, but only the U.S. offers the prospect of strong economic growth in the coming decades. This bolsters the case for continued investment in the U.S., especially since trend productivity growth remains high.

Many of the newly industrializing countries of Asia save one-third or more of their national income. We

believe that this high Asian savings rate will be slow to fall. The consequence is likely to be persistently high external deficits in the U.S. combined with the continued availability of financing for these external deficits.

A Third Mouth To Feed

As foreign economies age in the future they may want to utilize the claim on real goods and services that they are now accumulating by financing the U.S. external deficits. The degree to which this eventually becomes a problem for the U.S. depends on whether there is strong enough growth in the U.S. economy to meet the future economic needs of three groups: U.S. workers, U.S. non-workers (young and old) and foreign creditors. **Foreign creditors will be a third mouth to feed for the U.S. in the coming decades, competing with U.S. workers and U.S. non-workers for a share of U.S. national income.**

Conclusion

The pessimists argue that continuing dollar weakness is the default outcome of economic imbalances since big enough policy changes to sharply reduce the trade and current account deficits are unlikely. While they might ultimately prove correct, we believe that the most likely case is that the recent rise in real yields in the U.S. relative to real yields in other major industrialized countries should contribute to a stabilization in the dollar against other financial currencies.

While we believe that the U.S. may soon be nearing the peak quarterly rate for the trade deficit and possibly even the current account deficit, a stall near current levels is likely and any decline in either measure should be gradual. We believe that a persistent U.S. current account deficit near 6% of GDP is unsustainable in the long run. There is no intrinsic reason why the U.S. current account deficit needs to drop to zero. We believe that a U.S. current account deficit of 3% to 3.5% of GDP and its associated rise in external debt would be sustainable due to favorable relative demographics, flexible markets and favorable long-term economic trends. While the population in the U.S. is aging, it is doing so at a slower pace than in Europe or Japan. Despite the current dollar problems, in the long run foreign investors are likely to have a substantial demand for U.S. investments.

Our most likely case is that the U.S. dollar is in an extended stabilization against the key financial currencies, within what will probably prove to be a long-term orderly downtrend. Evidence of the continued strength of the U.S. economy in 2005 relative to its industrial competitors has continued to accumulate. While this economic strength stimulates U.S. imports and thus a persistently high trade deficit, it also contributes to an upward shift in U.S. real yields (actual yields minus inflation) relative to real yields in other industrialized countries. This is likely to generate enough demand for dollars to help finance the continuing external deficits, at least for a while. So far, the dollar has not declined primarily against what it should (the renminbi and the other currencies of non-Japanese Asia) but rather against what it could (euro, yen). We believe that is likely to change. The economies of Europe and Japan are fragile and could prove vulnerable in the event of significant further strength in their currencies. In contrast, non-Japanese Asian economies (including China) have been strong. The combination of low interest rates and low exchange rates in non-Japanese Asia has generated strong economic expansion, making some upward revaluation of their currencies appropriate. We expect that Asian currency strength, rather than dollar weakness, is likely to be the dominant theme over the next year and that the dollar will be in a period of stabilization against other major financial currencies.

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