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DEBT AND THE DOLLAR

The United States damages future living standards by borrowing itself into a deceptively deep hole

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The United States is currently borrowing \$665 billion annually from foreign lenders to finance the gap between payments to and receipts from the rest of the world, an amount equivalent to \$5,500 per American household. This borrowing entails serious costs for the U.S. economy. However, these costs have been hidden for the past few years, predominantly by the historically low interest rates, which resulted from the Federal Reserve's attempts to spur economic recovery after the 2001 recession and from a downturn in domestic investment. This happy scenario will not persist indefinitely, and when interest rates rise, the costs of U.S. borrowing will have serious economic consequences:

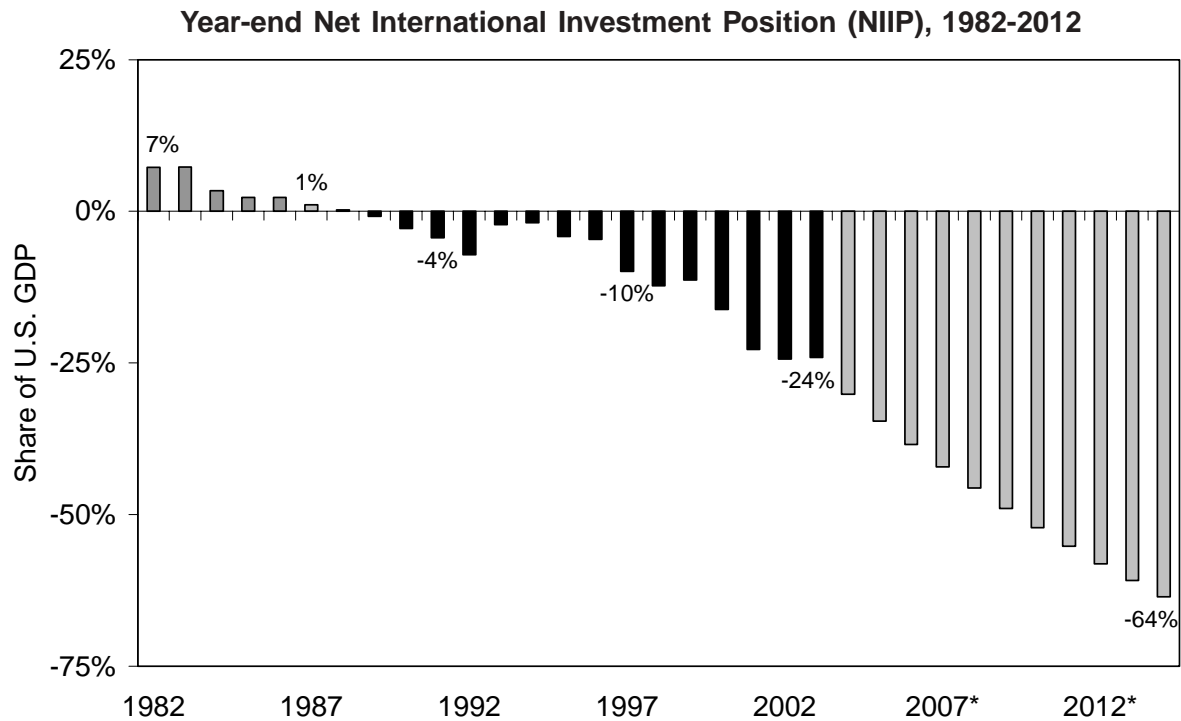
- With no improvement in the current account deficit, the external debt of the United States will rise from 24% of total U.S. gross domestic product (GDP) at the end of 2003 to 64% by 2014.
- The cost of servicing just the *additional* debt incurred from 2004 to 2014 will rise to 1.7% of GDP by 2014, the equivalent of \$250 billion in 2004 dollars.

Recent declines in the value of the dollar, while a welcome development, must be more broadly based among a larger cross-section of trading partners to bring the international accounts of the United States back into rough balance. Specifically, nations that actively manage the value of their currencies must allow the value of these currencies to rise vis-à-vis the dollar.

Background

In the second quarter of 2004, the United States posted a current account deficit of \$665 billion, or 5.7% of its total GDP, the largest in its history. The *current account* is the broadest measure of a nation's balance

FIGURE 1



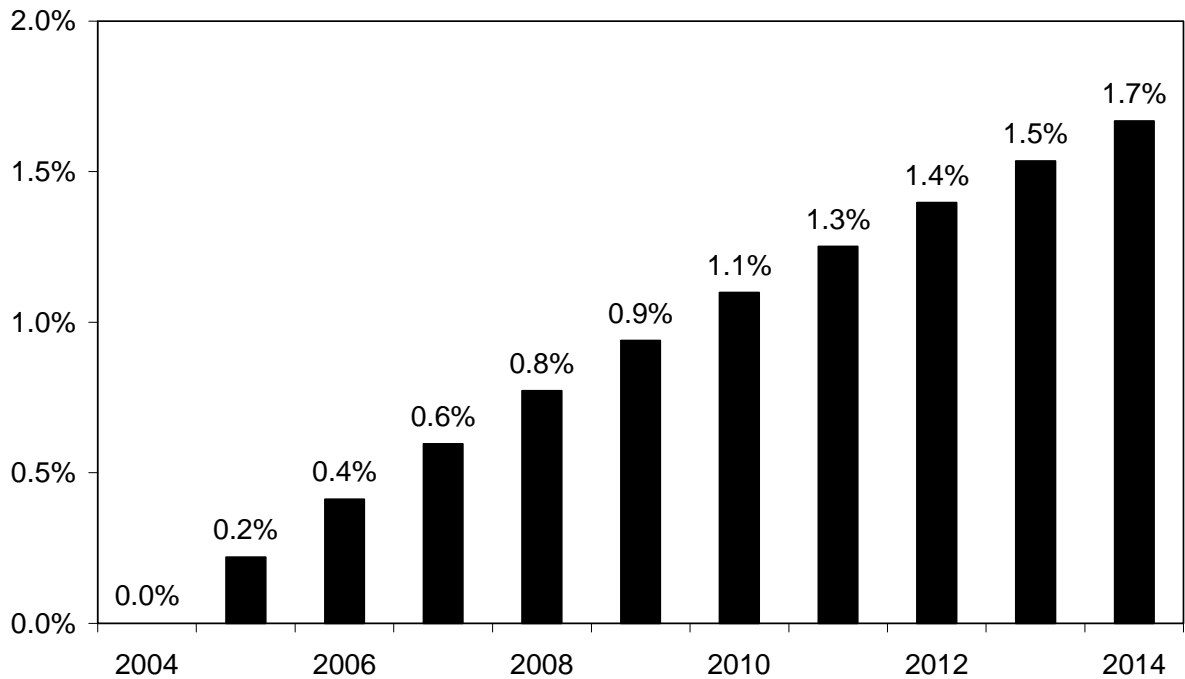
* Forcasted value.

Sources: Bureau of Economic Analysis (BEA) and author's calculations.

of income payments with the rest of the world, and it is the difference between a nation's *receipts* (exports and returns on domestic holdings of foreign investment) and its *payments* (imports and returns on foreign holdings of domestic investment). Just like a household that spends more than it earns, a nation must finance its current account deficit through borrowing.

This borrowing on the part of the United States has, predictably, led to an enormous foreign debt, or, more specifically, to a deterioration of the U.S. *net international investment position* (NIIP). This position has now reached -24% of the entire U.S. gross domestic product, a deterioration of 14% of GDP since 1997. Financing these obligations has been relatively painless for the past couple of years due to historically low interest rates. But economic policy makers cannot bank on these low rates forever, and within the next decade the economic consequences of rising U.S. external debt obligations will constitute a massive loss by American households of claims to future income generated by the capital stock of the United States. In a nutshell, although the U.S. economy may not be eating its seed-corn, it is financing current consumption by selling away today the claim to income generated by tomorrow's harvests. This is not a healthy state of affairs.

Figure 1 shows the magnitude of the deterioration of the NIIP in the United States by projecting it 10 years into the future under the assumptions that the current account deficit does not improve (or worsen) and that GDP grows at the rate forecast by the Congressional Budget Office (CBO 2004). Under these assumptions, the NIIP will grow to -64% of U.S. GDP by 2014.

FIGURE 2**Projected increase in international debt service burden, 2004-14**

Sources: Author's calculations from BEA data and interest rate forecasts of the Congressional Budget Office (CBO).

The longer the debt is allowed to grow, the more significant is the loss of future income claims and the more intense the pressure on American living standards. This loss of claims to future income can be thought of as the debt service costs arising from the borrowing implied by running current account deficits over this time. **Figure 2** shows the implied international debt service payments that will occur over the next 10 years, assuming that interest rates on this debt follow the projections of the CBO.

Given these assumptions, the debt service costs (or, again, the loss of claims to future investment income) just from the *additional* accumulation of foreign debt over the next 10 years would reach 1.7% of GDP in 2014. It should be noted that this is not a *prediction* of what will happen, just a *projection* of what current trends imply, given an assumed path of interest rates.

This projection is, in fact, quite conservative. It assumes that all of this investment yields returns equivalent to no-risk, low-return Treasury instruments, rather than higher-yielding instruments such as corporate debt or equity. Currently, this international debt service is essentially free, mostly because U.S. direct investments abroad earn a higher rate of return than do direct foreign investments in the United States, while interest rates on non-direct investment in both directions has been near zero. This free lunch will end soon, however, because gaps between foreign and domestic returns on direct investment are converging, non-direct investment is growing as a share of the total debt, and higher interest rates seem inevitable.

The role of the dollar

The recent current account deficit has been driven almost entirely by the merchandise trade account, with the gap between exports and imports (or, the *trade deficit*) accounting for about 90% of the overall current account deficit.

In turn, this trade deficit can be traced back to the rise in the value of the dollar that began in the second half of 1997. As the dollar rose, U.S. demand for imports was spurred by falling import prices, while foreign demand for U.S. exports was dampened by rising export prices. The result was a merchandise trade deficit equal to 5.2% of GDP in the third quarter of 2004, an increase of 4% of GDP since the beginning of 1997.

From 1987 to 1997, the real, broad, trade-weighted value of the dollar averaged 91 (with its value in 1973 = 100), and the current account deficit of the United States averaged a manageable 1.6% of GDP. Between January 1997 and January 2002, the dollar index rose from 90.5 to 113 and the current account deficit deteriorated by 2.5% of GDP (from a deficit that was already equal to 1.8% of GDP). Since January 2002, the dollar index has fallen back down to 94.6 (with nine points of the decline occurring in the past six months), while the current account deficit has continued to deteriorate.

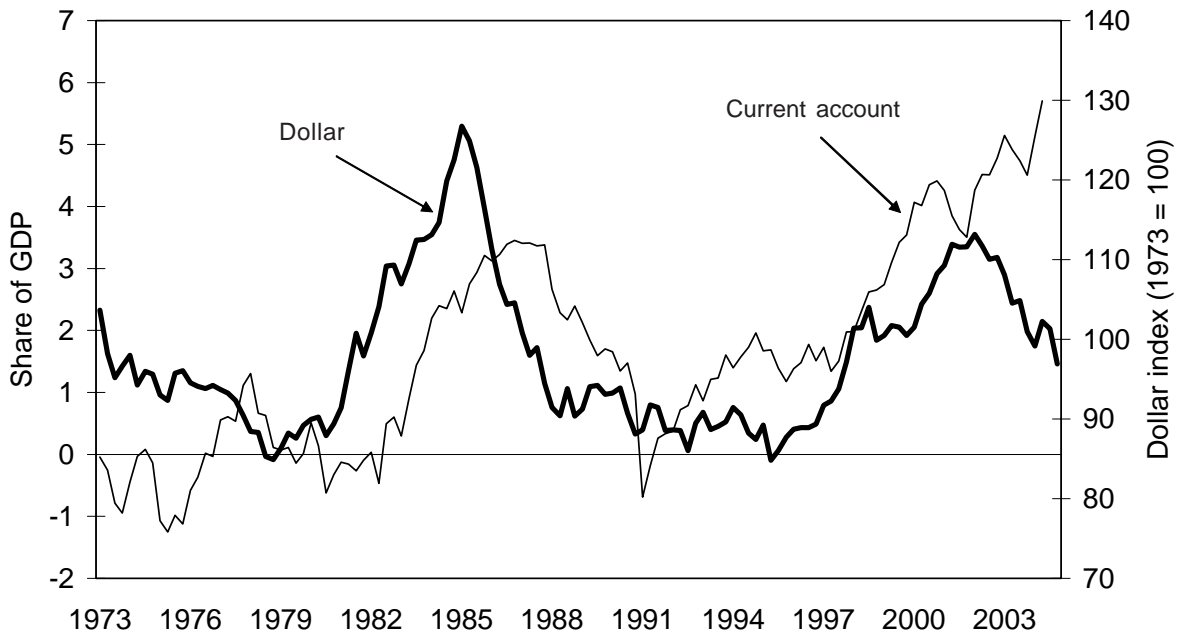
While this depreciation has been significant, it is still insufficient to bring the external accounts of the U.S. economy into even rough balance. Between the beginning of 1985 and the end of 1987, the dollar index fell from 124.5 to 91.8, which led (after a lag and some initial worsening in trade accounts due to “J-curve” effects¹) to a reduction in the current account deficit of less than two percentage points of GDP by the end of 1989. If this decline repeated itself today, such a correction (greater than what has transpired so far) would not even come close to cutting today’s deficit in half. All of these trends can be seen in **Figure 3**.

Today, the U.S. current account deficit is much larger than in the mid-1980s. Many of the United States’ trading partners have seen rapid increases in the sophistication and competitiveness of their economies over the intervening decade, meaning that a large dollar correction is warranted. A broad range of studies agree that the dollar still has a substantial adjustment to make. Forecasts from Obstfeld and Rogoff (2004) imply that adjustment will require a further 25% depreciation. Goldman Sachs has estimated that a 30% decline in the value of the dollar will be needed just to stabilize the NIIP at -55% of total GDP, while Mann (2004) argues that a 10% per year depreciation is needed just to keep the current account deficit stable over the foreseeable future.

Some economic observers may be surprised to hear the dollar’s correction so far labeled as insufficient to restore external balance to the U.S. economy. Lately, the news has been dominated by the large dollar depreciation relative to the euro, with the dollar reaching historic lows in recent months. This dollar/euro correction has been dramatic, and it is a necessary and stabilizing first step toward unwinding the U.S. current account deficits. However, further drops in the dollar’s value, while necessary, must be broader based, especially with regard to the bloc of nations whose domestic monetary authorities tightly manage the value of their currencies. For example, China, Malaysia, and Taiwan essentially enforce a *hard peg* of their currencies’ values against the dollar, buying up dollars on global markets to keep the value of their own currencies from rising outside of a very narrow band. These nations need to allow more substantial dollar adjustment.

FIGURE 3

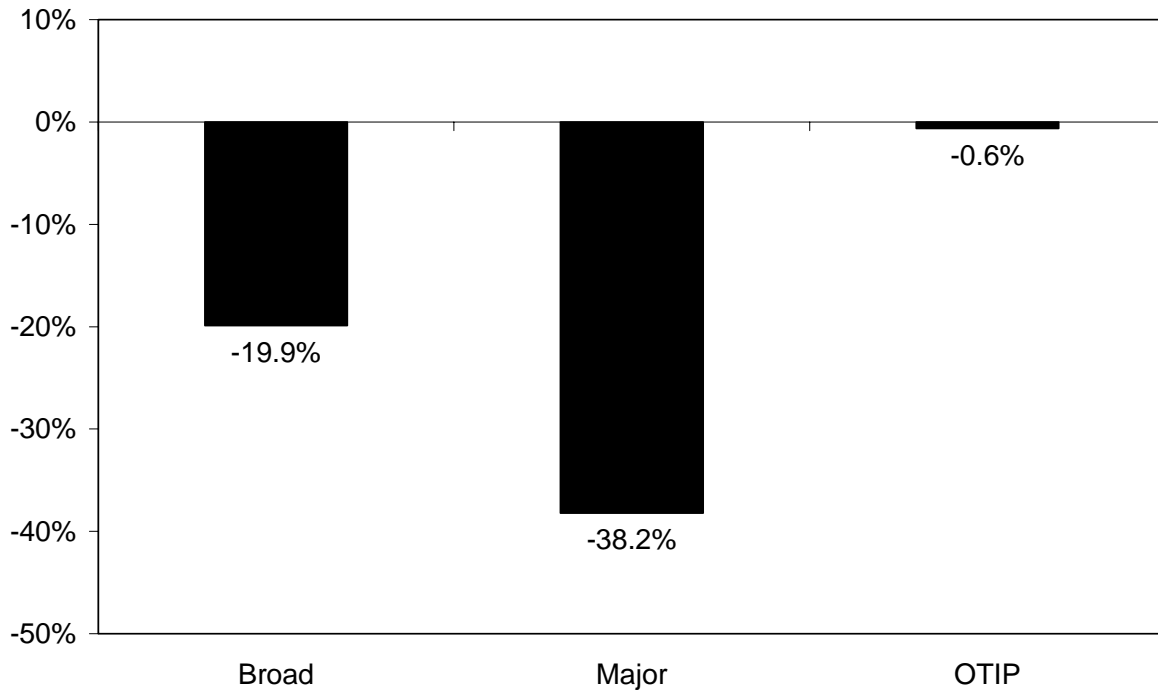
Current account deficit as share of GDP and real dollar index, 1973-2004



Sources: Current account data from the BEA; real dollar index is the broad, trade-weighted index reported by the Federal Reserve Board.

FIGURE 4

Change in three dollar indices, January 2002 - present



Sources: All indices reported by the Federal Reserve Board.

Figure 4 outlines the broad parameters of this story by tracking movements in the three real, trade-weighted currency indices compiled by the Federal Reserve. The *broad index* includes all U.S. trading partners, with each currency weighted by the country's share of total trade with the United States. This index has declined significantly since its February 2002 peak (and its decline has accelerated recently), but still has yet to reach the levels that existed before 1997 (when the U.S. current account seemed on a manageable path). As discussed earlier, the index may well have to drop quite far below this pre-1997 level for external balance.

The *major* currency index is a basket of currencies, including Canada, the euro area, Japan, the U.K., Switzerland, Australia, and Sweden, which comprises about 55% of the trade with United States that is tracked by the broad currency index (54% of imports and 58% of exports). This index, led by the euro, Canadian dollar, and British pound, has gained considerable value against the dollar over the past two years. Importantly, the monetary authorities of the countries in this index do not generally enforce a hard peg of their currency against the U.S. dollar; only the Japanese Central Bank engages in any degree of currency managing, and they do not enforce a hard peg.

The *other trading partners index* (OTIP) tracks the remaining most important trading partners of the United States—including Mexico, China, Korea, Taiwan, Singapore, Hong Kong, Malaysia, Brazil, Thailand, Indonesia, the Philippines, Russia, India, Saudi Arabia, Israel, Argentina, Venezuela, Chile, and Colombia. This group constitutes the remaining 45% of total trade that is captured by the broad index (46% of imports and 41% of exports). This index has essentially not moved at all over the past couple of years, reflecting the fact that many of these currencies (especially those of nations with the largest bilateral trade flows with the United States) are tightly managed by monetary authorities in these countries with the explicit goal of keeping them competitive in American markets.

Conclusion

The current U.S. international debt path is damaging to future U.S. living standards. This damage has not materialized yet because interest rates have been at historic lows in recent years, making U.S. borrowing extraordinarily cheap. However, it would be irresponsible for economic policy makers in the United States to bank on these low rates. As soon as the interest rates begin to rise in the United States, the full consequences of the U.S. international debt problem will have real bite.

The U.S. traded goods sector has a key role to play in bringing the U.S. economy closer to current account balance. To boost net exports, the United States needs countries that peg the value of the currencies at low levels relative to the dollar to revalue their currencies. This does not imply that these nations should be encouraged to abandon capital controls and allow their currencies to “float.” This would, in fact, be a bad idea. Rather, these countries should just allow their currencies to rise to a sustainable level against the dollar in a one-off revaluation.

Recent U.S. dollar depreciation against a select group of currencies, especially the euro, is a welcome first step toward returning the current account balance of the United States to a reasonable level. These currencies, however, cannot bear the entire burden of this adjustment.

Endnotes

1. The “J-curve” refers to the fact that changes in trade volumes lag change in trade prices, meaning that the current account usually worsens before it improves following depreciation. For example, after dollar depreciation, U.S. imports become more expensive, but the import volumes do not immediately fall, as U.S. consumers take time to adjust their purchasing patterns and U.S. producers need time to increase production of import-competing goods.

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