IMF delivers strong warning on growth of US debt

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The International Monetary Fund has sounded the alarm on the state of US finances, warning that the growth of external debt and the increase in the budget deficit are threatening global financial stability.

The warning came in a 60-page report entitled "US Fiscal Policies and Policies for Long-Run Stability" published last Wednesday. It said that large US budget deficits posed "significant risks" for the US and the rest of the world and that the rising US external debt, estimated to hit the equivalent of 40 percent of gross domestic product within the next few years—an "unprecedented level" for a large industrial country—could destabilise international financial markets.

The rising US demand for finance from the rest of the world—its balance of payments deficits currently absorb about three quarters of the world's surpluses—coupled with a decline in the value of the dollar "could possibly lead to adverse consequences both domestically and abroad". This could produce a collapse in international investor confidence in the US pushing up interest rates, leading to cutbacks in investment and a rapid slowdown in the world economy.

Addressing a press conference briefing on the report last Thursday, Charles Collyns, deputy director of the IMF's Western Hemisphere Department, noted that the US federal budget had swung from a surplus of 2.5 percent of GDP in 2000 to a deficit of just under 4 percent of GDP in 2003. While this would provide a short-term boost to the economy, the "emergence of large fiscal deficits and signs that they will be sustained at substantial levels unless corrective action is taken, raises a number of longer term and multilateral concerns."

Rising deficits and lower American savings would eventually lead to higher real interest rates, both in the US and the rest of the world, while the increased federal debt resulting from the deficits would make the problems of funding social security and health care more difficult. In addition "sustained higher fiscal deficits are likely to exacerbate the global imbalances that are reflected in the very large US current account deficit and corresponding large financial needs."

Collyns conceded that cyclical expansion in the US economy would absorb some of the spare capacity in the economy and lead to a reduction in the federal deficit through the increase in tax and other revenues. "[E]ven assuming tight spending limits and a sharp rebound in revenues, this would still leave a structural deficit of around 2 percent of GDP with the economy operating at full capacity," he said.

In order to deal with this structural deficit there was an "urgent need to reform Social Security and Medicare" requiring that "difficult social and political choices be faced."

Asked to outline the possible "adverse consequences" flowing from a "disorderly" adjustment of international currencies as a result of the growth of US debt, Collyns pointed out that the current account deficit (more than $500 billion) and the next external liabilities of the US (close to $3 trillion) "are rising quite rapidly relative to both US GDP and relative also to global savings."

"Therefore, we feel there is a substantial risk that the foreign investors' appetite for US assets, and particularly US government assets, will over time diminish. And we think, at least to some degree over the past year, this has occurred, and this is one of the reasons why there has been weakness in the US dollar."

A disorderly situation, set off by a rapid movement in exchange rates, would have an impact on equity and asset prices in both the US and globally.

So far, Collyns noted, the downward movement of the dollar had been fairly smooth but even this had "complicated macroeconomic policy management in other countries such as the euro area and Japan. And we are concerned if the US fiscal problem is not addressed, then the problem could become even more difficult."

The problems of "macro management" arise from the fact that a fall in the US dollar and the consequent upward pressure on the value of the euro and the yen lead to the growth of recessionary tendencies in both the European and Japanese economies. These pressures were underscored by the remarks of European Central Bank chairman Jean-Claude Trichet on Friday. Pointing to the rise of the euro, which has gained more than 12 percent against the dollar over the past two months, he emphasised that the bank did not like "excessive volatility" in foreign currency markets. Germany's economy and labor minister, Wolfgang Clement, said the strong euro was "a problem for the economic development of Europe" while EU trade commissioner Pascal Lamy has warned that the euro is approaching a level that could pose problems for the competitiveness of eurozone exports.

For their part, Japanese authorities announced last month that they had spent a record amount in international currency markets last year buying up US dollars and trying to prevent a too rapid rise in the value of the yen which would snuff out the growth in export markets at present sustaining the limited recovery in the Japanese economy.

While Collyns made clear that the IMF considered the global environment was quite favourable to economic recovery, the "very substantial decline" in the US dollar was making it more difficult for the Japanese and European authorities to "manage their situations."

The Bush administration responded to the report by dismissing its findings. White House officials said the IMF had been wrong to criticise the Bush tax cuts in the past and action was already being undertaken to reduce the budget deficit.

Asked to comment on Treasurer John Snow's statement that the administration would cut the deficit in half within five years and bring it down to about 2 percent of GDP, Collyns said while the commitment could be achieved on the basis of current policy it would rely "to a substantial degree" on the continued cyclical upswing in the US economy. Moreover, the administration commitment was not enough. The IMF's baseline projections, he said, were based on the assumption that the reductions could be achieved but even if they were there would "over time" be further increases in the federal debt-to-GDP ratio.

While Collyns was necessarily somewhat restrained in his response to Bush administration criticisms, an editorial in last Friday's *Financial Times* was positively scathing.

"The administration's reaction to the IMF's criticism was to intone the mantra that it plans to halve the federal deficit in five years. Higher economic growth, it says, will raise tax receipts. But as a commitment to long-term fiscal responsibility, this is disingenuousness bordering on dishonesty."

According to the editorial, the problem was not so much that the US, facing a recession at home and a weak economy abroad, had run up twin fiscal and current account deficits, but that the administration had elected to push a tax cut for the rich instead of using the money to put Social Security and Medicare on a fully-funded footing.

The Bush administration, it continued, had inherited in the US economy "one of the most flexible and forgiving systems in economic history. But like a 16-year-old driving her mother's Ferrari, it seems determined to see just how irresponsible it can be before the machine goes off the road. It should not ignore the grown-ups who shake their heads as it speeds along the highway."