US indebtedness a growing threat to global stability

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A study released last week on the present disequilibrium in the world economy points to the continued threat to financial stability posed by the never-ending growth of US indebtedness.

The report, which examines global current imbalances and their impact on currency exchange rates, is the third in a series of papers published by academics Maurice Obstfeld and Kenneth Rogoff over the past five years. Both are well-known economists, with Rogoff having served for a period as chief economist at the International Monetary Fund.

They begin their analysis by pointing out that the US current account deficit is running at around 6 percent of gross domestic product (GDP), that the US is currently soaking up about 75 percent of the combined current account surpluses of the rest of the world and that to balance its current account simply by increasing exports, the US would have to increase revenues by 70 percent over 2004 levels.

Their "overall assessment" is that the risks of "collateral damage" to the global financial system, apart from risks to exchange rate stability, have "grown substantially" over the past five years.

This is not simply because of the growth of the US current account deficit. Other factors are involved, including: the "stunningly low" personal savings rate in the US—down to 1 percent in 2004 compared to the average of 7 percent over the past three decades—the US government's growing budget deficit, rising energy prices and the fact that the US has become increasingly dependent on Asian central banks to finance its deficits.

If a sudden economic shock were to take place, the two authors conclude, "the damage might well be contained to exchange rates and to the collapse of a few large banks and financial firms—along with, perhaps, mild recession in Europe and Japan. But given the broader risks it would seem prudent to try to find policies to start gradually reducing global imbalances now rather than later".

However, any significant move by the US economy toward balancing its international accounts will lead to global turbulence. According to the Obstfeld-Rogoff analysis, if the US current account deficit halves (that is, moves from 6 percent to 3 percent of GDP) Europe will lose export markets, due to a relative decline in the value of the dollar of about 25 percent, as well as experiencing "huge losses" on foreign asset holdings.

The *Economist* has recently noted the scale of such potential losses. At the end of 2004, it estimated that over the past three years the decline of the US dollar was 35 percent against the euro and 24 percent against the yen, with the stock of dollar US assets held by foreign investors standing at $11 trillion. "If the dollar falls by another 30 percent, as some predict, it would amount to the biggest default in history: not a conventional default on debt service, but default by stealth, wiping trillions of the value of foreigners' dollar assets."

While they do not regard their analysis as "particularly alarmist," Obstfeld and Rogoff argue that "any sober policymaker or financial analyst ought to regard the United States current account deficit as a potential sword of Damocles hanging over the global economy".

Pointing to what they call "Panglossian views," they take issue with the "deceptively reassuring" analysis offered by US Federal Reserve chairman Alan Greenspan. In a number of speeches Greenspan has acknowledged that the US "is unlikely to be able to continue borrowing such a massive percent of income indefinitely, and recognises that the US current account will likely close sharply some day". However, according to Greenspan, increasing global financial integration has both allowed the US to run such large deficits and will be the saving factor in cushioning the effects of their eventual unwinding.

"Enhanced global financial integration may well facilitate gradual current account and exchange rate adjustment," they write, "but it might also promote the development of large unbalanced financial positions that leave the world economy vulnerable to financial meltdown in the face of large exchange rate swings." In other words, financial globalisation is a "two-edged sword". On the one hand, it increases available financial resources. On the other hand, by tying all financial institutions closer together, it increases the speed with which a disturbance in one region can be transmitted through the financial system.

The speed of the financial decline of the US is highlighted by the brief historical review contained in the paper. Having fluctuated between +1 percent and -1 percent of GDP during the 1970s, the US current account started to move into deep deficit in the mid-1980s, reaching a level of 3.4 percent of GDP in 1987. It recovered slightly at the end of the 1980s and even attained a small surplus in 1991, not least because of the $100 billion transfer of funds from foreign governments to help pay for the Gulf War.

The current account began a steady deterioration in the 1990s, reaching the record deficit of 6 percent of GDP in 2004 and now requiring an estimate capital inflow of between $1.5 billion and $2 billion per day to finance it.

This inflow of funds has enabled the Federal Reserve Board to keep interest rates at historically low levels. These low rates have in turn become the main driver in house price appreciation, which has played such an important role in financing increased US consumption spending in the recent period.

Morgan Stanley chief economist Stephen Roach noted in a recent comment that "equity extraction" from ever-rising property values in the form of home equity cash-outs and second mortgages was $710 billion over the past four years. This was 35 percent larger than the cumulative growth of earned wage income over the same period.

Continued current account deficits have led to a rapid deterioration in the US net foreign asset position. In 1982, the US held net foreign assets equivalent to just over 7 percent of GDP. Today it has a net foreign debt amounting to around 25 percent of GDP. But this figure will rapidly increase if present trends continue.

If US nominal GDP grows at 5.5 percent per year and the current account deficit remains at 5.5 percent of nominal GDP, then the net foreign debt to GDP ratio will begin to approach 100 percent and "few countries have ever reached a level anywhere near this without having a crisis of some sort".