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The International Dollar Standard and the Sustainability of the U.S. Current Account Deficit

FOR MORE THAN twenty years the world's richest, most mature industrial economy has drawn heavily on the world's limited pool of saving to support high consumption—in the 1980s by the federal government, and in the 1990s by households. Over the past decade, personal saving has fallen more than government saving (as manifested in the recent budget surpluses) has increased. The huge deficit in the current account of the U.S. balance of payments, equivalent to about 4.4 percent of gross national product (GNP) in 2000, reflects this saving gap. In order to support a normal level of gross domestic investment (historically about 16 to 17 percent of GNP) as well as this increased consumption, America has had to draw heavily on the saving of the rest of the world. On a flow basis, the United States now attracts more capital, net, than all developing countries combined.

The international balance sheet of the United States has declined in corresponding fashion. From being a net creditor to the rest of the world at the beginning of the 1980s, the United States transformed itself into the world's largest net debtor—to the tune of an incredible $2 trillion or more—by 2000. The cumulative effect of this private foreign borrowing

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over the last ten years is now reflected in the balance sheets of both American firms *and* American households. The indebtedness of the personal sector is now a record 1.03 times disposable income; firms in the aggregate also show a very high indebtedness relative to cash flow.

Should Americans worry about this anomalous situation? After all, the dollar remains strong, and the United States is unique in having a virtually unlimited line of credit with the rest of the world, which is largely denominated in its own currency. American banks and other financial institutions are relatively immune to currency risk because both their assets, which are largely claims on the domestic economy, and their (deposit) liabilities, of which a substantial fraction is owed to foreigners, are denominated in dollars.

Other debtor countries must learn to live with currency mismatches when their banking and other corporate international liabilities are dollar denominated but their assets are denominated in the domestic currency. Indeed, this kind of mismatch was the genesis of the great Asian currency crisis of 1997–98. Because Indonesia, Korea, Malaysia, the Philippines, and Thailand had large outstanding, short-term dollar liabilities, they became extremely vulnerable to a currency attack, and the resulting devaluations bankrupted their domestic financial institutions. In contrast, no matter how precarious and overleveraged the financing of American borrowers—including American banks, which intermediate such borrowing internationally—might be, they are invulnerable to dollar devaluation.

Does this invulnerability to currency crises simply reflect the greater strength of the American capital markets and the greater wisdom of American regulatory authorities, compared with other industrial countries? No. The fact that the United States is the preferred and highly favored international borrower is pure serendipity. How did this accident of history come about?

The International Dollar Standard

In the immediate aftermath of World War II, confidence in the currencies and financial systems of all the other industrial countries in the world had evaporated. To prevent capital flight mainly to the United States, the European countries as well as Japan imposed tight exchange controls. The relatively stable U.S. dollar was the only major currency in which

international exchange could freely take place. In the late 1940s, under the Bretton Woods monetary order, other nations declared official exchange rate parities against the dollar, making it the central numéraire for the system. This official monetary order did not create asymmetry among currencies; it simply recognized it.[1] Thus was the dollar enthroned as "international money."

When this system of official exchange rate parities broke down in 1971, the dollar was not dethroned. To the present day, the dollar is still the main vehicle currency in the interbank spot and forward exchange markets, the currency of invoice for primary commodity trade and for many industrial goods and services, and the main currency of denomination for international capital flows—particularly short-term and interbank flows. Outside of Europe, governments use the dollar as their prime intervention currency, often unofficially pegging to the dollar, and U.S. Treasury securities are widely held by foreign central banks and treasuries as official exchange reserves.

This status of the dollar as international money, providing the central currency in the world system, is a natural monopoly. Consider first a world of n national currencies in which there is no official intervention or foreign exchange targeting by governments. In organizing private interbank markets for foreign exchange, great savings in transactions costs can be had if just one national currency, the nth, is chosen as the vehicle currency. Then all foreign exchange quotations—bids and offers—at all terms to maturity can take place against this one vehicle currency. The number of active markets can be reduced from $n(n - 1)/2$ to just $n - 1$. In a world of more than 150 national currencies, this represents a tremendous economy of markets for the large commercial banks that make the foreign exchange market. The dollar's interbank predominance (it is on one side or the other of almost 90 percent of interbank transactions) allows banks to cover both their forward exchange and their options exposures much more efficiently.

Trade in goods and services shows a similar pattern in which one national money is used as the main currency of invoice. Exports of homogeneous primary products such as oil, wheat, and copper all tend to be invoiced in dollars, with worldwide price formation in a centralized exchange. Spot trading, but especially forward contracting, is concentrated at these centralized exchanges—which are usually in American cities such

1. McKinnon (1996).

as Chicago and New York, although dollar-denominated commodity exchanges do exist in London and elsewhere.

Except for those from the large European countries, exports of heterogeneous services and manufactured goods also tend to be invoiced in dollars—even exports from Japan. In intraregional trade in Asia and Latin America, the dollar is overwhelmingly used for invoicing of both primary commodities and manufactures. And all countries trading directly with the United States itself see both imports and exports invoiced in dollars.

Having once been settled on for whatever historical reason, the dollar offers huge economies of scale for its continued use as the central vehicle in international exchange. (The major exception is the strong regional role played by the euro for countries on the fringe of the European Union.) Among the other 150 or so countries in the world system, the more that countries A and B use the dollar in international exchange, the more attractive (that is, cost reducing) it becomes for countries C and D to do so. In effect, the dollar could now only be deposed by some cataclysmic event, such as massive inflation in the United States.

The Nominal Anchor

In periods of reasonable confidence in American monetary policy, like that we have witnessed over the past decade and, before that, in the 1950s and 1960s, these *dollar* prices of goods and services are relatively invariant to fluctuations in the dollar's exchange rate. In contrast, any other country that allows its exchange rate to fluctuate against the dollar will experience a higher rate of pass-through of those fluctuations into its domestic goods prices; if its currency weakens against the dollar, it will also experience problems with servicing its short-term dollar liabilities to foreigners. (Again, Europe is a partial exception.) The upshot is what Guillermo Calvo and Carmen Reinhart call "fear of floating": most countries are reluctant to let their exchange rates float freely against the dollar.[2]

What are the monetary implications of not floating? To an important degree, other countries subordinate their domestic monetary policies to the

2. Calvo and Reinhart (2000).

effort to prevent, not always successfully, short- and medium-term fluctuations in their dollar exchange rates. Of course, high-inflation countries must let their currencies fall against the dollar over the long term, but in noncrisis periods even they strive to stabilize their exchange rates from one day (or one week) to the next.[3]

Consequently, possessing the *n*th currency in an *n*-currency world, only the United States has the freedom to conduct its own monetary policy independently (except in great crises) of exchange rate fluctuations—creating for other countries what Robert Mundell called the "redundancy problem."[4] Essentially ignoring the dollar's exchange rate against other currencies, Federal Reserve Chairman Alan Greenspan can focus on stabilizing the American price level and the purchasing power of the dollar in terms of real goods and services, and at this he has been quite successful. Then the American price level becomes the (informal) nominal anchor for the international monetary system.

When the dollar-based nominal anchor seems secure as it does now, unlike in the 1970s when inflation was high and variable, this reinforces the willingness of other countries to target their dollar exchange rates (again putting aside the euro zone as a quasi-independent monetary regime). They become very reluctant to see their currencies depreciate against the dollar because of the longer-term inflationary threat. And they may be even more reluctant to see any substantial appreciation of their currencies against the dollar, for fear of losing mercantile competitiveness in world markets in the short or the medium term. In particular, countries are most unlikely to jettison, or even to stop accumulating, their huge official exchange reserves—which are mainly dollar denominated and often consist of U.S. Treasury securities. Such a selloff would provoke a sharp appreciation of their currencies against the dollar. Willy-nilly, foreign governments cannot avoid being important creditors of the United States.

America's Soft Borrowing Constraint

Although this central monetary role for the dollar is all well and good for promoting more efficient international exchange, an incidental consequence is that the United States itself faces a much softer constraint on its

3. McKinnon (2001).
4. Mundell (1968).

own international borrowing. As the rest of the world's income grows, the demand by foreign enterprises and governments to build up their stocks of international liquidity rises commensurately. America can provide these liquid dollar assets—whether paper currency, claims on American banks, U.S. Treasury or government agency bonds, or (although these are somewhat less liquid) various private bonds or stocks—all of which are claims on American firms and households *with no well-defined time frame for net repayment* for the country as a whole.

The closest analogy to the United States' position is that of a central bank issuing fiat money within its own national monetary domain. Although banknotes and coins may formally be liabilities of the central bank, in practice they never have to be redeemed, because the private sector's demand for domestic money is ongoing. Analogously, on an international scale, the collectivity that is the United States can issue to the rest of the world liquid claims on itself that "never" have to be redeemed.

For the last twenty years, the United States has chosen to exploit this soft borrowing constraint by absorbing capital on a net basis from the rest of the world. But this need not be the case. An efficient dollar standard does not depend on America's running current account deficits to provide international liquidity. Even without such deficits, the rest of the world could still have built up the dollar liquidity it so craves.

In fact, in the 1950s and 1960s the United States ran large current account surpluses. However, its long-term capital outflows—including illiquid direct investment abroad as well as development aid—exceeded these current surpluses. This payments gap was then covered by more liquid and generally shorter-term capital inflows: foreign firms built up their liquid stocks of U.S. bank deposits and money market instruments, and foreign governments built up stocks of U.S. Treasury securities. Like a giant international financial intermediary, the United States lent long to, and borrowed (less) short term from, the rest of the world.[5] Through these gross capital flows, the United States satisfied the world's growing demands for dollar liquidity while remaining a *net* creditor.

If, in the new millennium, the United States manages to return to current account balance or even begins to run surpluses, the rest of the world could still quite comfortably get the liquidity it seeks through greater long-

5. Despres, Kindleberger, and Salant (1966).

term lending by the United States. But if we accept the hypothesis put forth here that the U.S. line of credit with the rest of the world is indefinitely long, why not just keep borrowing to cover current account deficits? Are American consumers not better off if they can continue to keep their expenditures above their incomes by continuing to borrow?

Financial Fragility

There are two big problems with continuing the status quo of running large current account deficits. The first is that it leads to excessive borrowing and declining creditworthiness on the part of individual American households and some firms. The second is an increasing threat of protectionism as the large trade deficit continues to erode America's industrial base.

The first problem, the overleveraging of American households and firms, is aggravated by the ability of banks and consumer credit companies to finance themselves too cheaply on international markets. Either directly or indirectly, these institutions can easily sell liquid dollar deposits and other financial instruments to foreigners to finance the proliferation of consumer credit and mortgage lending in the United States. The resulting incredibly low net worth of American households with moderate incomes makes the macroeconomy more vulnerable. For example, the large household debt overhang could well aggravate the cyclical downturn in 2001 by inducing a sharp rise in household bankruptcies—and a sharp decline in consumer spending more generally.

To a degree, the American corporate sector is less vulnerable to overleveraging from the economy's soft borrowing constraint in international markets. Foreigners can and do buy not just debt but also equity claims on American corporations—they acquire U.S. stocks as well as corporate bonds and commercial paper. Thus the debt-to-equity ratios of most American companies, although still uncomfortably high, need not continue to rise as more foreign capital flows in. To the extent that overleveraging by companies is a problem, it is more one of U.S. tax law and corporate governance.

No one, however, including foreigners, can buy equity claims on American households. Thus, insofar as the influx of foreign capital softens household budget constraints, the result is a greater buildup of household

indebtedness. American banks as (international) financial intermediaries are "special" in two important senses. First, they lend to domestic economic units—American households and small firms—that cannot finance themselves through the direct issue of stocks or bonds in primary securities markets. Second, foreign claims on American banks are an important component of international liquidity for which the rest of the world's demand is rather strong. Although heavily indebted American households may not seem to be borrowing from foreigners, they are indeed doing so indirectly through the intermediation of domestic banks and finance companies.

The Dutch Disease and Protectionism

The second problem stems from a political-economic restraint on American trade deficits, namely, the transfer problem. Foreign saving can only be transferred to the United States through large U.S. current account deficits, that is, by allowing American expenditure to rise above American income. For any given level of income, this means a reduction in American exports (broadly defined) and an increase in imports. And because of peculiarly heavy state intervention and protectionism for agriculture and some services around the world, it is the industrial sector that typically bears the brunt of adjustment to such a swing in the trade balance.

To accommodate the trade deficit, other things remaining equal, American manufacturing industries must contract, on both the export side and the import-competing side. Boeing will have a much tougher time competing against Airbus in aircraft, Xerox against Ricoh in copiers, Ford against Toyota in automobiles, Caterpillar against Komatsu in heavy equipment, and so on. Indeed, America is largely exiting, or has exited, certain industries—such as photographic equipment that includes the latest digital technologies—altogether. Even where the United States has a technological lead, as it does, for example, in computers, integrated circuits, and Internet-related equipment, the rate at which American firms farm out their production to overseas affiliates will be greater because of the need to transfer net capital from the rest of the world.

A purist might say, "If this is what the market dictates, then so be it." But in some sense "the market" is biased by international monetary con-

siderations that give the United States a uniquely soft and uniquely long credit line with the rest of the world. If American consumers exploit this credit line—or the issuers of credit cards cajole them into doing so—the resulting capital inflows and strong dollar will lead to a trade deficit. This international monetary version of the Dutch disease has led to an unusual shrinkage in America's industrial base, which continues today.

More important, the political obstacles to preserving free trade are increased when the trade deficit is large. A declining American export sector reduces the supply of lobbyists in favor of keeping foreign markets open reciprocally with the domestic market. A second political obstacle is the perception, correct or not, that a large trade deficit reflects "unfair" trading practices by foreigners, and that the government should do something offsetting to protect American industry.

During the recent "Goldilocks" period of the American economy, from 1995 through 2000, an unusually low rate of unemployment and an unusually rapid rate of growth dampened these underlying protectionist pressures. However, once the economy slips into a cyclical downturn, with rising unemployment and widespread industrial bankruptcies, protectionist pressure will reappear with a vengeance. The recurrent bouts of Japan-bashing before 1995 could well be superseded by episodes of China-bashing in 2001 and beyond. In the longer run, the political economy of preserving free trade on a world scale would be much easier to sustain if the center country's trade accounts came into better balance.

Tax Cuts the United States Can Afford

There is another danger. In 2000, through the large budget surplus, the federal government contributed to national saving (to the tune of over 2 percent of GNP), thus partly offsetting the private dissaving that generated the trade deficit. If the surplus is reduced by the massive tax cuts passed by the Congress in May 2001, without in the process generating a substantial increase in U.S. personal saving, America's huge current account deficit will surely increase still further.

Beyond credit cards, an important aspect of the problem of low personal saving is that Americans are putting aside far too little in their pension plans and then taking out too much. Both behaviors are tax driven. Thus any tax "cuts" should take the form of much higher ceilings on personal

tax deductions for pension saving, while allowing older people to accumulate funds within their pension plans indefinitely without facing tax penalties.

Eliminating, or at least substantially recrafting, the federal estate and inheritance taxes could further increase the incentives for American households to save in order to pass more wealth on to the next generation—both inside and outside their pension plans. New retirees would no longer be so eager to convert the capital in their pension funds into annuities and thus consume it all over their own lifetime. They would be more content to leave some portion of their pension accumulations as a lump sum if they knew it would not be subject to the estate tax. In any case, putting all of one's retirement capital into a fixed annuity is risky: there is no margin for error should one be hit with some unexpected expense.

These are but two examples of how tax cuts might increase American households' propensity to save. A proper menu of tax and other institutional reforms would go well beyond what can be covered here. The bottom line is that, if one takes the balance of international payments into account, tax reforms that demonstrably increase private saving should be at the forefront of what the new administration is considering. But this is a lot to consider and perhaps too much to hope for.

Is the Dollar Standard's Survival at Stake?

Like most writers on the subject, Catherine Mann, in an extraordinarily comprehensive statistical analysis in her book, *Is the U.S. Trade Deficit Sustainable?* treats the United States as just another important large country.[6] It has some special economic features, to be sure, but nevertheless it is similar to other countries with large debts in that it must ultimately pay back what it has borrowed. She concludes:

> All told, this calculation for the investor constraint alongside the borrower constraint supports the notion that the US current account is sustainable for at least two or three more years, or even longer as judged by the investors' constraint.[7]

From her analysis, if the American current account deficit remains high, then capital flight from the dollar, higher U.S. interest rates, and a weak

6. Mann (1999).
7. Mann (1999, p. 163).

dollar will eventually be with us. But any such sustained flight from the dollar, besides forcing a correction in the American current account deficit, would also undermine the international dollar standard.

My own view is that the only real threat to the dollar-based institutions of international exchange could come from chronic inflation in the United States itself. Absent monetary instability in the center country, the dollar standard is robust and could continue without the United States running up against significant borrowing constraints from the rest of the world. Any incipient run on the dollar would be offset by foreign central banks accumulating dollar reserves in order to prevent their currencies from appreciating, because to do otherwise would impose a loss on their countries' international mercantile competitiveness. However, for reasons adumbrated above, the world and the U.S. economies would be better off if the American current account deficit were smaller or nonexistent.

Most people would suppose that America's ability to attract vast amounts of capital from the rest of the world in the 1990s hinged on the extraordinary boom in the "Goldilocks" economy of those years, which made the United States a great place in which to invest. Indeed, Mann worries that if growth in the United States should slow down and growth pick up in the rest of the world, a sharp reversal of net capital flows could occur—possibly leading to substantial dollar depreciation.[8]

However, faster growth in the rest of the world would also increase the demand for international liquidity. Foreign firms and financial institutions—including central banks—would become even more willing to accumulate dollar bank balances, Treasuries, and so on. Provision of this liquidity would amount to a countervailing capital flow back to the United States. Thus, from the perspective of the monetary economics of the world dollar standard put forth here, the dollar—and its special place in the world economy—need not be vulnerable to the kind of relative slowdown in the U.S. economy that Mann and others fear.

8. Mann (1999, p. 174).

APPENDIX

Disappearing U.S. Treasury Securities—Should We Worry?

IN HIS REMARKS of last January 25 advocating cuts in tax revenue in 2001, Federal Reserve Chairman Greenspan deemphasized the usual Keynesian argument for a countercyclical economic stimulus. Taking a longer perspective, Greenspan worried instead that large fiscal surpluses—on projections that assume no tax cut—would eliminate the stock of Treasury bonds held outside the Social Security system. The Office of Management and Budget estimated in June 2000 that debt held by the public (that is, excluding that held in U.S. government accounts but including that held by the Fed) would be fully redeemed by 2012. Already signs abound that the open market for Treasuries is becoming less complete intertemporally, and thus less liquid, with the discontinuance of new issues of one-year bills and possibly of thirty-year bonds as well.

If the fiscal surpluses continued after all Treasury securities had been retired, the American government, including the Fed, would have no choice but to start acquiring claims on the private sector with its surplus tax revenue. Greenspan sees the government granting credit to, or acquiring ownership claims on, private agents as far too intrusive. However, if tax cuts were geared mainly to inducing more private saving through, say, individual 401(k) plans, the net worth of American households would likely improve. The macroeconomic fragility induced by overleveraging would be reduced. And in principle, households could demand more Treasuries with their increased saving. However, demand for a safe and "neutral" liquid asset from important financial institutions—the Fed itself, commercial banks, insurance companies, and their foreign counterparts, including other central banks—would almost surely dominate bidding for the extant stock of Treasuries (much as it does now). With saving-inducing tax cuts, therefore, the Greenspan "problem" of overly intrusive government in the private financial markets would be solved *without* increasing the current account deficit.

In contrast, if the tax cuts went beyond providing incentives to increase private saving by Americans, the supply of Treasuries to world markets would certainly increase. However, the cost would now be an increase in the current account deficit *without* any reduction in the precarious financial

fragility of American households. And the share of outstanding Treasuries held by foreigners would surely rise.

In the absence of any U.S. tax cuts (or expenditure increases), can the world dollar standard survive the elimination of Treasuries from international markets? In 2000, foreigners held about 42 percent of Treasury securities not held by U.S. government trust funds or by the Fed, and about half of these foreign holdings were by official institutions such as central banks or treasuries. Official foreign exchange reserves can be huge: Japan holds the equivalent of more than $350 billion, China $150 billion, Hong Kong, Korea, and Taiwan $100 billion each, and so on for lesser amounts across almost every country in the world. Most of these exchange reserves are in dollar assets, with a high proportion in Treasuries.

Free of default risk, Treasuries are seen as *the* risk-free asset in the world's capital markets. Because the U.S. federal government owns the dollar-creating central bank (the Fed), it can always create the means of settlement on its own debt—whether held domestically or by foreigners. Under the world dollar standard, no other country can similarly create international money at will.

Undoubtedly, the attractiveness of Treasuries as an international asset has contributed to the very elastic line of credit with the rest of the world that the United States has exploited for the past twenty years. But having such a safe reserve asset, with assured international purchasing power, is also a great convenience to other countries in the world system. With the dollar so commonly in use as a vehicle and invoice currency, finding an equally liquid replacement to use as an international reserve asset would be difficult.

But not impossible. In the absence of Treasury securities, foreign central banks and finance ministries could experiment with holding dollar assets such as bonds or stocks that are claims on the American private sector—or on foreign issuers of dollar-denominated debt, although this would be inherently more risky. In any event, credit risk in official reserve holding would be more of a problem. And then Greenspan's dilemma would arise in an additional guise: foreign governments, as well as the U.S. government, would intrude on the financing of private American companies!