

The US economy: an update

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In a previous article published in this *Review* (Sacchetti 1999) I highlighted four trends in the US economy which I believed to be not sustainable. It was stated that a reversal was likely, but that the time of the turnaround was not predictable. My opinion remains unchanged. In what follows I shall rapidly review three of the four trends, and shall give a factual account of what happened during the last 4 to 5 years. The fourth trend, i.e., the developments in the country's external accounts, will be discussed in more details because of the magnitude of the problem, of the difficulties to solve it due to its complexities and because of the possible implications, for the US and the world economy, if a solution is not found (and even if it is found through an organized approach).

In a broad perspective, it can be stated that at least from the financial point of view (but potentially also from an economic point of view) the country is in worse condition than in 1998. It is highly leveraged throughout. The federal budget, which was in surplus in late 1990s, closed the fiscal year 2003-04 with a deficit of \$ 413 billion, in sharp contrast with a surplus of \$ 69 billion in 1998, and high surplus of \$ 236 billion in 2000. Consumers increased their indebtedness in all forms (mortgage, equity lines of credit, revolving loans); and, due to the rapidly increasing current account deficits, the country's debtor position *vis-à-vis* the rest of the world has considerably worsened. At the end of 2003, it was -2,651 billion dollars compared with -1,322 billion dollars in 1997. It should be mentioned, however, at the same time that the GDP rose from \$ 8.995 trillion in Q2 1998 to \$ 10.778 trillion in Q2 2004, or by 19.8%. This period included a minor recession in 2000-01. After that recession the rate of growth was heavily influenced by a number of measures in the fiscal and monetary fields.

□ Wilmington, N.C. (USA).

They included: tax rebates and lower income and capital gains tax rates, a gradual steady reduction in the federal funds rate, which was lowered to 1% in early 2002 and remained in negative territory (in real terms) until to-date (2.25% nominal); and a long-term interest rate policy (facilitated by heavy purchases of Treasury bonds by Asian countries) which allowed the public in general to obtain additional sizable spending power through: refinancing of mortgage loans at substantially lower interest rates, the assumption of additional real estate loans via home equity loans and lower credit card rates. As in the Kahn-Keynes income multiplier sequence, however, the effects of a one time impulses tend to peter out in a relatively short period of time, although refinancing and equity loan borrowings constitute repeated impulses which affect positively the economy over a longer period of time.

Of the trends under review, only that of the stock markets suffered a major reversal. The Dow Jones industrial average fell from about 11,500 to a low of 7,286; and the Nasdaq fell from about 5,050 to a low of 1,039. The Standard and Poor price-earnings ratio improved, as a result, to a recent level of 19.8, although this is still higher than a conventional norm of about 15.

The trend of weekly earnings of private non-farm employees resumed a slight upward trend, as their index (2000=100) rose by some 17% from 1999 to October 2004. The average annual rate of increase of about 3.2% was, however, barely above the inflation rate during the same period of time which, in real terms, cannot be viewed as a significant reversal of the previous trend. Two main reasons may have prevented the weekly earnings from rising at a faster rate: the fact that the Federal minimum wage was not increased, and remained at a very low level; and the continuing policy of leniency towards illegal immigration, which allowed many companies, particularly in the construction sector, and some services sectors, to hire unskilled employees at very low wages, thus keeping a downward pressure on wages. Other reasons were at play, including the 'outsourcing' of some services which displaced a number of wage earners.

Finally, the trend in consumer credit continued unabated. This took place even during the period starting in 2001 when consumers were able to obtain additional purchasing power by the mentioned tax benefits and substantial additional borrowings via home equity loans and mortgage refinancing. The outstanding amount of consumer credit

rose from 1.520 trillion dollars in 1999 to 2.053 trillion dollars in September 2004. By that time the ratio of personal savings to disposable personal income had fallen to 0.2%.

Focussing now on the developments in the external accounts, and in the dollar exchange rates, it may be recalled that in our previous article I stated, *inter alia*: “It is, therefore, very difficult to envisage what set of measures and circumstances can produce a gradual elimination of the deficit in the US external accounts, a goal which is clearly unavoidable” (Sacchetti 1999, p. 85). I also wrote: “Whereas a future break in the trends is *certain*, and a reversal in at least some of them is *probable*, the timing of these events is uncertain” (Sacchetti 1999, p. 84). In the case of the external deficit, the facts show that so far no reversal has taken place; and we can only take refuge in the statement that the timing was uncertain. While we can find comfort in being in the company of scholars, analysts and others, all of whom have stressed the unsustainability of the deficit during the many years past – and in recent months almost daily in the financial press – the phenomenon is of such a magnitude that it calls for a fresh reconsideration. Let us first examine the facts.

Table 1 includes the data of the balance of payments on current account of the US and of selected countries; and Table 2 shows the foreign exchange reserves over the same period of time of the countries included in Table 1.

TABLE 1

BALANCES ON CURRENT ACCOUNT
(Billions of US dollars)

	1997	1998	1999	2000	2001	2002	2003	2004
United States	-127.7	-204.7	-290.8	-411.5	-393.7	-480.9	-530.1	-620.0
China	37.0	31.5	21.1	20.5	17.4	35.4	45.9	n.a.
India	-3.0	-6.9	-3.2	4.4	0.2	5.8	n.a.	n.a.
Japan	96.8	118.7	114.6	119.7	87.8	112.4	136.2	n.a.
Argentina	-12.2	-14.5	-11.9	-9.0	-3.8	9.1	7.8	n.a.
Brazil	-30.5	-33.8	-25.4	-24.2	-23.2	-7.6	4.0	n.a.

Source: IMF, *International Financial Statistics*.

During the period from 2002 to date the US dollar: *a*) depreciated by almost 40% against the euro, and by similar percentages against other free market currencies (British pound, Swiss franc); *b*) depreciated by a smaller percentage against the Japanese yen and *c*)

remained at a stable, or near stable, level *vis-à-vis* the Chinese yuan, the Indian rupee and other currencies of Asia's emerging countries. After 2003, the dollar was approximately stable *vis-à-vis* the Brazilian real and the Argentinian peso.

TABLE 2

FOREIGN EXCHANGE RESERVES
(Billions of US dollars)

	1997	1998	1999	2000	2001	2002	2003	2004
China	139.9	145.0	154.7	165.6	212.2	286.4	403.3	609.9*
India	24.3	27.0	31.0	37.3	45.3	67.0	97.6	115.6**
Japan	207.9	203.2	277.7	347.2	387.7	451.5	652.8	817.7**
Argentina	22.1	24.5	26.1	24.4	14.5	10.4	13.1	16.8**
Brazil	19.6	17.6	16.8	15.9	16.5	12.7	19.2	48.9**

* December

** October

Source: IMF, *International Financial Statistics*.

The above data reveal a number of important aspects. The first is that there was a great acceleration, in absolute terms, in the US current account deficit during the period 1997-2004. In 2004, the deficit (estimate) was larger than in 1997 by about \$ 492 billion whereas during the period from 1984 (the first appearance of a sizable deficit) to 1997 the deficit rose by only \$ 89 billion. Both the periods 1984-97 and 1997-2004 included a minor recession.

The second aspect is that the 2001 recession only caused a minor, temporary reduction in the deficit. The deficit in 2004 (estimate) is about 5.2% of the GDP, whereas it was at about 1.5% in 1997. The rate of GDP growth cannot be used however, as a reason, by itself, of the deterioration of the current account deficit. China, with a much faster annual rate of growth, registered current account surpluses in each of the years of the period 1997-2004 and, to a lesser extent, so did other Asian emerging countries and countries elsewhere. The acceleration of the US deficit has to be attributed, therefore, to other important factors; and it will be shown that the picture is much more complex than explainable by simple macro-economic relationships (e.g., the relative rates of savings in terms of GDP).

A further observation is that, starting in 1997, China, India and Japan had increases in foreign exchange reserves highly correlated with the rate of change in the US current account deficit, and that Argentina and Brazil also increased their reserves during 2003-04. Intuitively, it is

inescapable to view that correlation in light of the exchange rates developments mentioned in an earlier paragraph.

The above elicits a short digression on exchange rates in general. The maintenance of stable, or near stable, exchange rates for the US dollar by the countries mentioned above was the result of deliberate policy decisions (and similar policies were followed at the same time by other Asian countries, such as Singapore, South Korea, Taiwan). The major – if not the sole – immediate objective of these policies has been the maintenance of a price advantage for the countries' exports, for the ultimate purpose of supporting or promoting domestic economic growth and employment. Those policies cannot be distinguished, in all their intents and purposes, from the policies followed by a number of countries in the 1930s labeled as competitive depreciation policies (or alternatively, beggar-thy-neighbor policies). Such policies, because of their deleterious effects, were prominent in the minds of the framers of the Statute of the International Monetary Fund (IMF). So much so that "To promote exchange stability, to maintain orderly exchange arrangements among members, and *to avoid competitive exchange depreciation*" (my italics) is one of the basic purposes of the IMF. This purpose is spelled out in Section 1 of Article IV of the IMF's Statute; and yet the subject, strangely, does not appear to have been raised – to the best of my knowledge – either within the institution or within the official or unofficial international financial establishment.

Having laid out the main components of the financial background, an explanation of the US current account deficits (which could provide clues for its possible solution) requires an examination of some broad feature of the world economy.

Arbitrarily separating the US economy from that of the rest of the world, it can be observed that, over the past three decades, the world productive structure has undergone a substantial rearrangement. Starting approximately in the early 1980s, more or less coincidentally with the rapid appreciation of the US dollar, the US economy has been gradually de-industrialized. First was the creation of so-called 'hollow' corporation, which entailed the transfer abroad of the physical production, while the company remained in name a US company. Then, over the years, foreign investments and the transfer of technology to less developed countries resulted in a large number of manufacturing activities being *de facto* 'transferred' from the United States to

those countries. This was facilitated by an unprecedented acquisition by low-qualified manpower of technical skills, and by the low wages prevailing in a number of Asian (and some Latin American) countries. And even the remaining industrial apparatus in the US is not working at full capacity, as will be shown in a later paragraph.

In the rest of the world the most important structural changes have taken place in developing countries, China in particular. What stands out is the creation and rapid expansion of their manufacturing activities, in practically all branches, from labor intense products (textile, garments) to products with high technological content, including aircrafts (Brazil); and, between those sectors, an extremely large array of home appliances and low price 'gadgetry'. In a sense, this is the mirror image of the process of the US de-industrialization. A similar development has been the expansion of the production, in those countries, of cereals, soya beans and derivatives, industrially processed fruit derivatives, etc., permitted by the acquisition of modern technology by large countries, such as Brazil, China, India; as well as the expansion of the production, especially in the southern hemisphere, of a large variety of perishable foods which have been exported in increasing quantities to developed countries, particularly the United States, during the 'inverted' season when the domestic competition is absent. In the United States this has significantly altered the balance of trade in agricultural goods. The large export balance that, historically and still not long ago, was one of the features of US foreign trade, is apparently disappearing, since the export surplus declined from \$ 27.3 billion in 1996 gradually to \$ 9.6 billion in 2004: and the estimate for 2005 is a further decline to about \$ 4 billion.¹ Finally, the combination of acquired technical skills, including foreign languages, and of a low wage structure, has created conditions which favor the expansion of those service sectors which provided electronically transmittable services previously performed in the United States and other developed countries.

¹ The balances for the (fiscal) years 1996-2004 are (in billions of dollars): 27,3 for 1996, 21,6 for 1997, 16,8 for 1998, 11,7 for 1999, 11,9 for 2000, 13,7 for 2001, 12,3 for 2002, 10,5 for 2003 and 9,6 for 2004.

1. Near term prospects

Against the above retrospective picture of the financial and ‘real’ world economy, the relevant ongoing and prospective trends which have to be taken into account for an understanding of the problem of global imbalances in external accounts, and for its possible solution, are:

in the United States

1. a continuing increase in the current account deficit (or, at best its stabilization) in view of its main determinants. This assumes an absence of a dramatic drop in oil prices and, most of all, that no important changes in economic and financial policies will be introduced both at home and abroad.

2. A continuing, and possibly rising, federal budget deficit, which during the 2003-04 fiscal year reached \$ 413 billion.²

3. The prospective issue of federal debt instruments to cover the expected deficits mentioned above.

4. The manifest inability of the US economy to rebuild its manufacturing base – and to expand its agricultural base – as evidenced by the continuing increase of US imports at a rapid rate even during the large dollar depreciation of the last two years, or so, and as evidenced by the declining trend of manufacturing as a percent of GDP from 1980 to 2002 (with a declining capacity utilization) as shown in Table 3.³

² The proposed budget for 2005-06 shows an expected deficit of \$ 427 billion. This figure, however, does not include supplementary appropriations for the military operations in Iraq and Afghanistan which are expected to be, at least, \$ 80 billion. Moreover, a federal agency, the Pension Benefit Guaranty Corporation (PBGC), which insures pension plans of private companies, is emerging as an increasing burden on the US fiscal operations. Its net financial position, which registered improving surpluses from 1996 to 2001, turned negative in 2002 (\$ –3.6 billion) and deteriorated further in 2003 and 2004, with negative positions of \$ 11.2 billion and \$ 23.3 billion, respectively. This trend is expected to continue, the major contributing factor being the possibility that large companies, which are in bankruptcy proceedings, particularly large airlines, could be authorized by the Courts to off-load their pension plans onto the PBGC. A study by a Washington DC ‘think tank’ recently concluded that the PBGC net negative position could become as large as \$ 100 billion.

³ There are certain factors which, in the near future, could make the reduction in the current account deficit, *ceteris paribus*, more difficult. They are: a) a possible, and

TABLE 3

UNITED STATES
INDUSTRIAL PRODUCTION INDEX (1997 = 100)
(GDP, manufacturing in billions of US dollars)

	Industrial production ^a 1	Capacity utilization ^a 2	Manu- facturing ^b 3	GDP ^b 3 4	as % of 4
1980	62.1	80.9	587	2,796	20.1
1983	61.7	74.8	693	3,534	19.6
1990	77.2	82.4	1,040	5,803	17.9
1998	105.9	83.0	1,431	8,781	16.3
1999	110.6	82.4	1,481	9,274	16.0
2000	115.4	82.6	1,520	9,825	15.5
2001	111.5	77.4	1,423	10,082	14.1
2002	110.9	75.6	1,448	10,446	13.9
2003	111.2	74.7	1,393 ^c	10,988 ^c	12.7

^a Source: Federal Reserve System.

^b Source: Department of Commerce – Bureau of Economic Analysis.

^c Both these figures are from a Department of Commerce revised series.

5. More generally, the dependence of the economic growth on massive injections of savings from abroad, largely in the form of Treasury bonds, and on impulses from growing consumer's debt, businesses' debt and federal and local government debt.

In the rest of the world

1. A continuation of accumulation of financial claims *vis-à-vis* the US by Japan, China and Pacific rim countries. An increasing percent of these claims is held by central banks, mostly in the form of US Treasury instruments (see below).

likely, increase in outsourcing of manpower due to low costs in developing countries, mostly in Asia; *b*) a possible continuing expansion of agricultural production in such large, low cost countries as Brazil, China and India, and its adverse effects on exports by, and import substitution in, the United States; *c*) the agreements recently negotiated by the US with groups of developing countries (headed by Brazil and China) which allow freer access of cotton, sugar and other products in the US market; and *d*) the expiration, at the end of this year, of a multifiber agreement within the WTO, with the elimination of import quotas, which would favor additional exports by China (also to the detriment of minor developing countries which would be unable to compete with China in an open market). These factors could cause not only the elimination of the US historical export surplus, but even the emergence of a deficit in trade in agricultural products, which would be a marked change from the surplus of about \$ 27 billion in 1996.

2. A continuation, possibly in dwindling amounts, of the support so far given to the US bonds market by the purchases of Treasury securities by the central banks mentioned above, and other central banks, particularly in Asia.⁴

3. An unlikely increase in the percentage of private capital inflow in the United States, after the sharp decline in this percentage in the recent past.

4. A possible continuation of the recently reported switches from the US dollar to the euro (the pound and the yen) by the mentioned central banks and by other official or unofficial holders, including Russia and OPEC countries.

5. In the particular case of China – and of other Pacific rim countries which follow China's lead – a continuing pegging, at least in the short run, of the yuan (renminbi) to the US dollar.

6. A continuing near stagnation, or low rate of growth, in the economies of the European Union; and, as a part of this expected trend,

7. a continuation of the limitation imposed on the countries of the euro group on budget deficits, and thus on fiscal stimuli on the economy, which results from a more or less strict enforcement of the 'stabilization pact'.

2. The search for a solution

The main features presented in the preceding paragraphs of the global environment, which have a bearing on external imbalances, include many more parameters, both substantially and quantitatively, than the usual discussions of the problem. In short, my position is that, because of important developments which have taken place during the last three years or so (see below), the problem has worldwide dimensions;

⁴ According to figures publicized by the US Treasury and the Federal Reserve, the holdings of US Treasury securities, as of September 2004, by the countries listed below amounted to 1,118.7 trillion dollars. This represents about 25% of marketable US Treasury securities. The holding countries and their holdings in billion dollars are: Japan 720.4, China 174.4, South Korea 66.6, Taiwan 57.4, Hong Kong 49.5, Singapore 24.1 and India 12.6.

i.e., it is not just a problem confined to the United States, or to the relationships between the US and China, as is usually presented. This introductory statement will be articulated in the remainder of this paper.

In the recent past the interest in the US external position has greatly intensified, in academia, in expert private publications and some authoritative pronouncements,⁵ and in the financial press, almost with a daily frequency. With few exceptions, the discussions essentially revolve around the following three basic questions: 1) since the US current account deficits are not sustainable, how long will they last, and what level can the deficit possibly reach? 2) Since non residents have largely financed those deficits, how long and to what extent will non residents, especially central banks, be prepared to purchase US financial assets? 3) Since a reduction in the deficit (and presumably its ultimate elimination) is necessary and desirable, to what extent can one rely on changes in the exchange rate (i.e., dollar depreciation) to achieve a rebalancing? Almost invariably, those questions do not receive specific answers, except for statements that savings should be increased in the United States and reduced abroad, i.e., that global demand should increase including imports from the United States.

While the intuitive questions stated above are by all means legitimate, their focus is only the financial aspect of the imbalances. As shown in an earlier paragraph, worldwide structural imbalances in the real economy have emerged, and they would have to be taken into account, alongside the financial imbalances. Moreover, three developments during the recent past also make it necessary to examine the problem within a worldwide context. The main reason is that they add a sense of precariousness with potential serious consequences. They are: *a*) the fact that the market for US Treasury securities has been supported by large continuous purchases of those securities by official foreign authorities; *b*) the fact that the current and prospective large US budget deficit will entail the issue and the marketing of Treasury securities; and *c*) the fact that in the recent past the demand for US assets by private investors has sharply declined. This stresses the role of foreign public authorities and the importance of policy

⁵ The latest publicized works, or statements, available to me are: Godley and Izurieta (2004), Mann (2004), Peterson (2004) and Summers (2004). The following are singled out as containing ample discussions of the problem: Sylos Labini (2003), Sacchetti (1986) and the works listed in Mann's (2004) references.

making decisions outside the United States for the stability and growth of the US economy.

The reason why this situation has the potentiality of creating a worldwide problem is that, if and when a policy decision should be taken by one or more important monetary authority outside the United States to end or drastically reduce the purchase of US Treasury securities – an event which is more and more likely as time goes by –, it would cause a considerable increase in long-term interest rates in the bond market and elsewhere in the US economy. Given the speed of transmission of interest rates changes across national borders, the economies of all the industrial countries would be clearly adversely affected.⁶

As usual, increases in long-term rates would adversely affect business investment, construction in general, purchases of homes; increases in short-term rates would adversely affect automobiles purchases and purchases financed by credit cards, to mention a few. Depending on the magnitude of the interest rates increases, the rate of growth of GDP would decline, or even turn negative. Valuations in stock markets would also decline, both as a result of lower profits, business failures and of switches from stocks to bonds due to yield differentials (at present, yields of S.P. 500 stocks are as low as 1.95%). These possible changes in the US economy would also be transmitted, though less rapidly, to the economies of industrial countries, via income and price effects; and also to developing countries via declining imports. The hypothetical sequence sketched above could be even more serious if non resident investors, especially central banks, decided to liquidate portions of their US Treasury securities holdings.

An antidote to the hypothetical developments in the US economy could be a decision by the Federal Reserve to purchase Treasury securities as much as needed to hold in check the rise in long-term

⁶ Another circumstance which could reduce the demand in the US bond market – and thus increase the rates – is likely to arise from changes in the so-called ‘carry trade’, which is prompted by the spread between the Federal funds rate and the rates in 5- and 10-year notes. So called hedge funds and even banks have been borrowing at very low overnight rates and invested in the notes mentioned above. When the Federal funds rate was, until not long ago, at 1%, the spread was about 3 percentage points. Since the policy of the Federal Reserve is to continue to increase its rates, the spread will gradually disappear (when the high risk premium is factored in) and so would the demand for bonds from this source.

interest rates.⁷ In this case the mechanism of transmission would ultimately not be different, since it would operate via inflation and higher nominal bond rates, with attending consequences, both at home and abroad, as outlined above.

Under the assumption of *ceteris paribus* the dire scenario outlined in the immediately preceding paragraphs has a high degree of probability and, once again, only the timing is uncertain. Many writers who share that view conclude that leaving the recent trends undisturbed would lead to a crisis (not otherwise described). To attenuate the results of the operation of the market forces, the policy making bodies of the governments most involved would have to take important decisions, which would include not only financial aspects but would also be broader in scope so as, at least, try to redress, to the extent possible, the imbalances in the world real economy. Single measures, such as a correction in the exchange rate of the renminbi and an even larger depreciation of the dollar, would not suffice. And the oft-repeated suggestion that the rate of savings in the US should be raised would appear rather simplistic, if not ineffective when viewed against the dimensions of the problem at hand. More penetrating measures may be necessary to solve the whole problem. To substantiate the above assertions a detailed discussion of those suggested steps is in order.

A further depreciation of the dollar (barring an exceptional high figure of, say, 30-40%) could have some effect on the trade balance, but would not cause a major reduction, let alone its elimination, for the reasons stated below: *i*) a depreciation, to be important, would have to be against the renminbi (and the Asian currencies which follow China's lead); *ii*) since this depreciation would be done by an administrative decision, the Chinese authorities would not likely be prepared to a change larger than 10% because their overall balance of payments surplus is relatively small, and because they would not risk to lose the stimulus to their economy by turning the surplus into a deficit. At the same time, a 10% appreciation would have only a marginal effect because of the large cost advantage that the Chinese products have

⁷ With reference to a possible rise in bond rates, Mr. Alan Greenspan, Chairman of the Federal Reserve Board, stated in December 2003: "If need be the Fed could hammer down long-term bond yields just as it has repeatedly cut short-term rates". A month earlier, Mr. Ben S. Bernanke, a Federal Reserve Governor, referred more explicitly to the "printing press" (Reported by James Grant, *New York Times*, 2003).

over the US products;⁸ *iii*) the large dollar depreciation which has already taken place against the euro and other free market currencies has produced no appreciable stimulus to US exports, despite the large unused industrial capacity, and no reduction in imports.

The suggestion that to improve the external deficit the US rate of savings should increase substantially has great appeal in principle, but under the present circumstances it is neither realistic, nor would it produce the wanted results without serious adverse consequences for the whole economy.

The formal presentation is:

$$M^t - X^t = I_d^t - S^t \quad (1)$$

where M^t denotes imports; X^t exports; I_d^t domestic investment and S^t savings, all at time t . The elimination of the deficit at time t_1 would mean that in the identity below $I_d^{t_1} - S^{t_1} = 0$.

$$M^{t_1} - X^{t_1} = I_d^{t_1} - S^{t_1} \quad (2)$$

Focussing on the right side of identity 2, it is noted that $I_d^{t_1} - S^{t_1} = 0$ could also, incidentally, be achieved by lowering $I_d^{t_1}$ to the level of S^{t_1} ;⁹ but, in the usual presentations, this route appears to be ruled out. Since comparing identity 2 to identity 1 is an exercise in comparative static, the basic question is: how do we get from S^t to S^{t_1} to make $S^{t_1} > S^t$? Whatever measure is used, an increase in savings would entail, *pro tanto*, a reduction in consumption spending. Since in the US the latter represents roughly two thirds of GDP, the economy would be subjected to a contractionary impulse between t and t_1 . Income induced investment would decline, and the rate of growth of GDP would also decline, and possibly become negative. In fact, it is difficult to see how, realistically, a substantial increase, in the rate of savings is feasible.

⁸ A recent "Special Report" by *Business Week* (2004) on the 'China phenomenon' highlighted unprecedented (by historical standards) characteristics of the Chinese economy and China's price advantages in a number of sectors. Without endorsing the figures stated in the report, the following price advantage over the United States are mentioned: in machine molds up to 50%; in networking equipment 25%; in bedroom furniture 40%; in LCD TV 30%; in crepe paper 45%.

⁹ This used to be the 'shock treatment' in stabilization programs negotiated by the IMF, where drastic monetary restrictions and cuts in budget expenditures would induce (temporary) disinvestment while a (presumed) reduction in inflation would induce increases in savings as consumers would end their anticipatory purchases because of an inversion in their inflationary expectations.

Less frequently mentioned, as a corrective factor, is a deep US recession. Such an event is not unlikely; but, as the experience of the two recent recessions shows, the correction would be modest and temporary. In any case, it would not generate investment in sectors which produce tradable goods, which would either increase exports or compete with imports.

In sum, neither a further depreciation of the US dollar, nor an implausible increase in savings, nor a deep recession, in the United States, are likely: *a*) to produce a rebalancing of the real economy in the US and the rest of the world; *b*) to reduce the world excess supply of tradable goods over effective demand, which, as pointed out, underlies the exchange rate structure and the veiled competitive depreciation in major emerging countries; and *c*) to reduce, to manageable proportions, the US current account deficit.

Achieving a restructuring in the world economy is a formidable, time-consuming task, especially in the United States. In addition to price measures (i.e., exchange rates) it may be necessary for the US to take temporary unorthodox measures, such as, among others, import restrictions or quotas, accelerated depreciation through fiscal measures for industries engaged in export and import trade, without excluding a dose of inflation which would reduce the real value of financial liabilities, including those *vis-à-vis* non residents. None of this, and more, can be achieved, however, unilaterally. A concerted international approach is necessary.

In principle, the countries with a surplus in their external accounts would also be interested in an internationally coordinated approach. Under the *status quo*, these countries, especially in East Asia, would have to face the prospects, willy nilly, of a continuous accumulation of claims in US dollars for an *indefinite* period of time. Besides the prospects of losses in value of such claims in international currency markets – which could be large especially if, as is likely, US Treasury bonds are, in any case, bound to decline in price – that accumulation would create increasing difficulties in managing domestic monetary policy, short of undertaking a wholesale sterilization of assets.¹⁰ The alternative to this sterilization would be increasing inflation in said countries, with the attendant gradual loss of price advantage in international commodity markets. To avoid that predicament

¹⁰ This subject was discussed by Higgins and Kitgaard in a recent essay (2004).

would be near impossible. Such countries could require that all their exports be paid in local currency, so that the central banks would not have to purchase the dollar excess from commercial banks (or directly from the market). This would allow them to avoid further accumulations of US dollar reserves; but they would still have to deal with the expansion of domestic money supply caused by the export surplus. Incidentally, a decision to require payments in local currency for exports would deprive the US dollar from the cushion of central banks' demand (i.e., reserve accumulation); and by throwing it into the open market it would result in its possible precipitous depreciation.

3. The elements of a coordinated solution. Is it feasible?

In a well thought-out recent essay, Catherine Mann (2004) took the position that “The United States and its Trading Partners have serious vested interests in the status quo” (the subtitle of the essay) which she labels as co-dependency. But she asks: “How long can this global co-dependency go on, and what are broader global ramifications of the US current account imbalance?” (p. 28). After outlining three possible scenarios (which are spelled out in some details), with the dollar undergoing hypothetical depreciation from 0 to about 10% per year, Ms. Mann estimates that the latter depreciation would keep “the current account from widening as a share of GDP” (p. 29). This would mean that in nominal dollars, and possibly in real dollars (unless the US experiences a more or less long recession), the deficit would expand. The basic (implicit) conclusion of the essay is that co-dependency cannot last forever and that

“Only a combination of structural change in the United States and abroad along with dollar depreciation appears to re-balance the global economies. Whether these changes can be accomplished before a global economic crisis forces them is an open question” (*ibid*).

It is unfortunate that no indication is given as to the nature and scope of the mentioned “structural change”.

Ms. Mann's essay focuses largely on the relationships between the US and Asian countries, particularly China. It is our position,

however, that all the major countries of the world have a stake in the solution of the imbalances. Because of this, I share Mr. Summers' suggestion (2004) that the whole matter should be dealt with in a broader forum than the G7, be it a G20, as Mr. Summers suggested, or an even broader one. There is a precedent of meetings with wide participation, which were held after 1971, following the United States' declaration of inconvertibility of the US dollar into gold. At that time the US took unilaterally other measures, including the imposition of a surcharge on imports; and it allowed the dollar to depreciate in terms of other currencies. The problem at this time is, however, even more complex because: *a*) an overall depreciation of the US dollar, *cum* appreciation of East Asia currencies, particularly the yen and the renminbi, are only first steps to produce the needed structural changes; *b*) the necessary rearrangements of productive activities require major policy changes, which some of the countries involved, in all likelihood, are reluctant to undertake for a variety of reasons; and *c*) even if those changes are introduced, it will take years to restructure the productive apparatus, and thus to correct large portions of the imbalances.

The possibility that major policy changes will be introduced must also be gauged against the background of apparent political drives by some of the emerging countries who have been successful in making inroads into the world scene. There are unmistakable indications that the Chinese authorities are intent in consolidating their gains and in expanding their influence into other parts of the world, particularly in large countries in Latin America, such as Argentina and Brazil investing in raw material sources for their further expansion, while diverting their surplus in US dollars away from purchases of Treasury securities. That political thrust is supported by the achievements in the economic area. Moreover, one cannot ignore that, in the play of raw political power, countries who hold large amounts of US Treasury securities have a powerful policy weapon in such holdings which they are not easily prepared to relinquish. That weapon resides in the possibility that massive sales of Treasury bonds, however hypothetical, during a short period of time could have serious consequences in the financial markets of the United States and of other industrial countries.

In a wide open international forum each country, or group of countries, would bring its own agenda. The list of items on these agendas would be a formidable one, not only because of its length, but

also because of the depth of the changes that some of the items would entail, and because of the inevitable conflicts between a number of them.

The United States would insist in a sizable appreciation of the currencies of those surplus countries which are now pegging their currencies to the US dollar, would request that other major partners mainly in Europe, adopt measures of economic expansion and would request a waiver for a number of years for the introduction of such changes outlined in an earlier paragraph (such as import restrictions and export promotion devices), which would aim at a substantial restructuring of the US economy. They could also request that some large holders of Treasury securities convert sizable portions of such securities into long term bonds, which would be non-marketable for a number of years.

The other major countries would insist that the United States take measures to balance the Federal budget within a relatively short period of time, reduce, in the interim, its dependence on foreign savings and adopt measures that would induce an appreciable increase in savings in the private sector of the economy.

Emerging countries and developing countries would require that the United States and other major developed countries reduce, and eventually, eliminate restrictions or impediments to the access to their markets of industrial and agricultural products and raw materials. Less developed countries would require, in addition, increases in financial transfers to them well above the recent levels, and that these transfers include investments to develop their industrial and agricultural resources. Some of these countries could also make demands for heavy foreign investments in technological education, so that emerging countries, as they mature, would be able to transfer to them labor intense industrial production facilities. Finally, those countries which are relatively important exporters of textiles would likely request that, after the elimination of quotas, following the expiration of the multi-fiber agreement, China use restraint in exporting those products to the rest of the world.

The above hypothetical agenda is an indication of the dimension of the problem; and, inevitably, engenders a feeling that, if an international meeting were to take place, the probability of its success would be next to nil. Achieving a partial success cannot be excluded but it would depend on the awareness of the participants of the conse-

quences of a complete failure. These consequences would be the result of the chaotic, brutal operation of the market forces (what a number of writers refer to as a ‘crisis’). In such an occurrence, a number of international organizations would be called upon (as in the case of the 1997-98 financial turmoil) to come to the rescue. And, in the face of the reality, a small group of countries, possibly the United States and other major players, would be forced to take limited coordinated measures to find *ad hoc* solutions to the most serious outcomes.

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