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UNEQUAL SPENDING, AGGREGATE DEMAND AND INTERNATIONAL FINANCIAL STABILITY

H. PETER GRAY*

Since 1945, the US dollar has been the key or reserve-currency of the international financial system. The chronic and ongoing series of large US current-account deficits from 1983 through 2004 (with a negligible exception in 1991) has now placed the US dollar in a vulnerable position. The cumulative deficits at annual rates of over \$0.5 trillion in 2003 and 2004 threaten the currency's ability to maintain the confidence that is necessary for it to continue as the reserve-currency. Easily-encashable dollar-denominated assets owned by private non-residents comprise Treasury debt, corporate stocks and bonds, and currency. These assets have increased from just under \$2.25 trillion in 1997 to over \$4 trillion at the end of 2003 (not including the liabilities of banks and other financial intermediaries to private non-residents). At the same time, the net international investment position of the United States¹ has worsened to approximately minus \$2.5 trillion. Continuing large current account deficits by the United States will increase its net indebtedness. It will ultimately cause private owners of dollar-denominated securities, non-residents and residents alike, to anticipate still further losses as the dollar continues to weaken in foreign-exchange markets and/or as interest rates rise to attract or retain foreign financial capital. The process is likely to become self-reinforcing as both components of the values of the securities to foreign residents, the domestic price in dollars and the dollar's rate of exchange against the home currency, will decline. In this way, net sales will reinforce pessimistic expectations and encourage further sales. US residents, who are pessimistic

about the dollar, will also have their expectations strengthened and will be tempted to take positions in securities denominated in foreign currencies to safeguard their individual wealth.

If the US current account deficit could be eliminated smoothly without financial crisis, the policy concerns would be the severity of the costs of adjustment placed on the US economy and its residents, and the costs of losses to non-resident owners of dollar-denominated financial assets. Most important, however, would be the repercussions of those events on the prosperity of the global economy. If the relevant markets become disorderly, the same areas of concerns exist but the accompanying degree of dislocation will be greater. The size of the US current deficits (of over \$600 billion in 2004) and the neglect of the deficits by official Washington suggest that a smooth adjustment is improbable and, in the absence of a miracle of global co-operation, serious stress in financial markets is unavoidable. The severity of any such crisis cannot be known *ex ante* but the possibility of substantial sales by US residents to acquire assets denominated in other currencies makes the potential crisis very severe indeed.

Section 1 of this paper examines the recent history that has led to the existing state of affairs. It identifies the macrofinancial linkages that exist² and reports on the package of measures that must be invoked by the US authorities if the deficits are to be seriously reduced. An assessment of the difficulties that must be faced in maintaining the level of global aggregate demand needed for a prosperous world economy follows in Section 2. Section 3 will show that major financial instability is quite feasible. The conclusion will draw the arguments together and will assess the inevitable need for the problem to be quickly, co-operatively and creatively addressed if major disruptions are to be avoided.

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¹ This number can be thought of as the balancing item in a country's international balance sheet.

² The term "macrofinancial" was coined in Gray (2004) to recognize the inseparability of the real and the financial sectors of an economy. Contagion between the two sectors is the inevitable aftermath of major stress. Too often, one of the two component sectors is excluded from analysis. Obstfeld and Rogoff (2004) is an example of such an approach, though the authors do refer to the possibility of instability in the financial sector as a limitation of their formal model.

More important than the costs of adjustment for the US economy are the repercussions on the prosperity of the world economy

The implications of current account deficits

A nation's deficit on current account is the first measure of the change in its net international investment position. The deficit represents collective dissaving (or overspending) by residents of one country with non-residents in the rest of the world. To measure the exact change in the net investment position, the current balance must be amended to include the effects of changes in the value of assets owned abroad by residents and at home by non-residents in the reporting currency. In this way, a weakening of a nation's currency is likely to generate an increase in the value of foreign assets and to ease the ongoing rate of decline in the net international investment position. The current deficits of the United States have grown steadily, but not monotonically, from \$82 billion in 1993 to something in excess of \$600 billion in 2004.³ The current surge began in 1998 when the annual deficit increased to \$204 billion from \$127 billion in 1997.

To reduce such a leakage of national wealth, the deficit country must sell more exports and spend less on imports of goods and services. For this to happen, the price-competitiveness of the deficit country must be improved by a weakening of its currency after adjustment for any induced price-level effects and/or the rate of total expenditure must be reduced. The higher costs of imports of intermediate goods must be passed through to domestic users and to export prices. Equally, the higher costs of imports must not be absorbed by foreign suppliers seeking to maintain their market in the deficit country. Put simply, the so-called real rate of exchange must be reduced by the depreciation of the deficit country's currency. There exist other means of improving the price-competitiveness of an economy and these can involve the whole panoply of measures that constitute commercial policy. These measures are, largely, inefficient ways to remedy chronic deficits and are not considered in this paper.

If the deficit country has a high rate of capacity utilization, its total use of resources including imports (its absorption) must also be reduced in order to create available capacity for more exports and import substitutes (Alexander 1952). Modern economic thinking suggests that a reduction in resource use

will not be generated by an adverse shift in the net barter terms of trade when the deficit amounts to 40 percent of US current credits as in 2003. Contractionary macrofinancial policies must be instituted by the deficit country's economic authorities. These measures will inevitably reduce the (rate of growth of) deficit of the central government and the real incomes of households. Elected politicians will be loath to take such measures if it is believed that they can be postponed (until after the next election). The need for contractionary measures is also due to the fact that many households will possess enough assets so that they will not be forced by less favorable terms of trade to reduce their rates of expenditure.

A kind explanation of how the United States allowed itself to get into this predicament is that it was conscientiously fulfilling the duties of the key- or reserve-currency country. In addition to providing a reliable repository for foreign reserves, one of the responsibilities of the key- or reserve-currency country is to add to global aggregate demand when necessary. If the reserve-currency country is to allow other nations to acquire international reserves without diminishing the level of global aggregate demand, it must run a current deficit equal to reserve acquisition. (This is the fatal flaw in an international financial architecture that relies on a national currency for its reserve currency.) A less benevolent explanation would attribute the size of recent deficits to the increase in US spending in the last four years. The deficit of the federal government has reached record amounts and saving by households has fallen from 3.73 percent of personal income in 1998 to 2.06 percent in 2002.⁴ Present conditions imply that the Bush administration has refused to recognize the possibility of the dollar being vulnerable even when, as in 2003, the country had to borrow to cover forty percent of its current purchases from abroad. This insensitivity may follow from the dollar having been the global key-currency for almost sixty years or by having Washington optimistically link super-power status with the impossibility of insolvency. Peterson (2004, p. xxii) reports that the Vice President in the Bush administrations was heard to announce that Reagan proved that deficits don't matter. A third possible explanation links the large inflows of portfolio capital to the increase in the strength of the dollar in the 1990s.

Politicians will postpone contractionary adjustment measures as long as possible, relying on the dollar's continued role as reserve currency

³ Complete data for 2004 were not available when this paper was written: the number used is the sum of the reported current deficits for the first three quarters of 2004 and for the fourth quarter of 2003.

⁴ The usual means of computing saving rates is from disposable (after-tax) income. These calculations use personal income to allow for the effects of the Bush tax-cut to be included.

The current deficit has not become smaller as the inflation-adjusted dollar has weakened sharply. It is difficult to attribute a responsibility for the large increases in terms of the size of the deficit in the last three years to portfolio inflows when the dollar has weakened in terms of the major European countries and by about 20 percent since 2002 on a broader, trade-weighted basis.

Any disturbance that impinges on the US financial system is likely to be magnified by the interdependence of the foreign exchange market and the markets for easily encashable assets. Non-residents own over \$500 billion of Treasury securities so that there exists a potentially close relationship between concerns about the vulnerability of US debt (because of the total outstanding debt) and the confidence of non-residents. A loss of confidence by residents in Treasury debt could quickly expand to the foreign-exchange market as non-resident owners unload Treasury securities. Similarly, the so-called real and the financial sectors are interdependent and a shock that exerts its major effect on one of those sectors will also indirectly generate a shock in the other. Put simply, net sales of dollar-denominated securities will increase the cost of capital in the financial sector. Stress in the financial sector will force increases in interest rates and slow economic performance even while foreign investors question a policy of leaving assets in dollar-denominated equities. These interdependencies and the failures of policymakers to fully comprehend the importance of sustained imbalances in the international financial system suggest that the simple interpretation of a self-correcting system of international markets for goods and for assets needs major qualification.⁵

The argument to this point suggests that official holdings of dollar-denominated assets will not be sold and transferred into different currencies. This imputed tolerance on the part of national economic authorities derives from their recognition that the elimination of the dollar as the global key-currency is likely to have severe adverse repercussions on the performance of their own economies. While the

economy of the debtor/deficit nation will suffer most, the inevitable reallocation of resources caused by a major realignment of exchange rates will adversely affect all of the major nations in the short and medium term. National economic authorities have, therefore, a vested interest in avoiding a financial crisis.

Global aggregate demand

National aggregate demand is recognized as an important component of modern economic policy since it directly affects the rates of employment and capacity utilization. In addition to domestic policies of changing the size of fiscal deficits and monetary policy, an important source of national aggregate demand can be a country's surplus on current account. Some nations rely heavily on this component. The fact that the world is a closed economic system and that global exports (international credits) must equal global imports (debits) is not as well recognized as a policy constraint. The nations of the world cannot, as an aggregate, run a current surplus, and imbalances merely redistribute aggregate demand among nations. This constraint has serious implications for the present conditions. The United States has been providing aggregate demand to the other countries in the global economy by running annual current deficits in excess of half a trillion dollars a year for the past two years and an average deficit of \$400 billion for the three years 2000 to 2002. When the United States is forced by the vulnerability of its dollar to reduce its current deficits severely (and even to run current surpluses), some other countries in the global economy will have to find alternative sources of aggregate demand. These will not be easily generated unless some chronically-surplus countries, which have been storing up reserves, are willing and able to reduce their own net international investment positions by running current deficits.

The United States will, to the degree that its policies of depreciation of the dollar and expenditure-reducing macrofinancial policies are successful in reducing its current deficit, enjoy an increase in demand for exported goods and services and for erstwhile imports of competitive goods. Other countries face excess capacity in export industries and the need to reallocate resources from these industries to produce goods for domestic markets. The reallocation of resources among different sec-

This interdependence of the real and the financial sectors implies that a shock to one will also generate a shock in the other

⁵ *The Economist*, (13th November 2004, p. 84) refers to the possibility that non-resident investors in dollar-denominated securities will lose money on these investments as, potentially, "the biggest 'default' in history." This language suggests that the US Government has perpetrated present conditions by design. The series of current deficits has gone on for far longer than it should have, but *caveat emptor* applies to purchases of securities as well as to purchases of eggs and melons. The appeal by Chancellor Schroeder in July 2003, for a weaker euro could be seen as a tacit approval of an even larger US deficit.

tors of an economy is a slow and painful process. The larger the reallocation, the greater are the social costs likely to be and the smaller will be the arc elasticities of supply. The United States, as the severely deficit country, will face the largest absolute need to readjust the mix of output and to reduce absorption.

Member countries of the euro bloc face a particular problem which will require flexibility and statesmanship on the part of the governments of the members of the bloc. The ability of the euro area as an entity to generate aggregate demand is constrained by The Stability and Growth Pact (Rehman, 1997, pp. 424–9). The Pact was originally designed to prohibit the creation of severe stresses on the new unified currency by the existence of different rates of inflation in member countries. A maximum permitted ratio of federal deficit to gross domestic product was set at three percent: excesses were to be punished by fines. Currently, three large economies in the euro area are seen to be operating beyond the prescribed limits for domestic reasons. While these countries will not be able, legitimately, to generate more aggregate demand through fiscal policy, the constraint is not absolute. Additionally, other member nations could exercise their unused fiscal latitude, much of their increase in demand should spread throughout the euro area to the benefit of the three nations which are running excessive deficits.⁶

The likelihood of financial crisis

Mainstream economic analysis does not easily confront the possibility of discontinuities that are substantial enough to warrant the word “crisis”. However, the possibility of the dollar having to face a critical range of instability in the foreign exchange market is very real. The way in which this will happen will become more easily apparent if one regards the key-currency country as a bank with a large volume of liabilities that can be easily and quickly withdrawn. There is no formula to judge the adequacy of the foreign exchange reserves of the key-currency country in the same way that various formulae have been concocted for commercial banks. However, the

principle is the same. The greater the volume of liquid liabilities and the more depositors are able to share information, the greater is the probability of a run on the bank. Paul Volcker, Alan Greenspan’s predecessor as chairman of the Board of Governors of the US Federal Reserve System, has been quoted as saying that there is “a 75 percent chance of a currency crisis in the United States within five years” (*The Economist*, 13th November, 2004, p. 84). For financial instability to be avoided, it is necessary for the United States to maintain the confidence in dollar-denominated securities of both non-resident and resident asset-holders. This requires that the economic authorities adopt the classic but politically unpopular measures of reducing the outstanding deficit on current account and, perhaps even more painful, the related fiscal deficit of the federal government. The record of the first George W. Bush administration does not inspire optimism either in the recognition of the problem or in its willingness to reduce absorption.

There exist, in addition, two potentially serious developments in the last twenty years capable of aggravating the volatility of funds when a crisis in foreign-exchange markets is anticipated. The first derives from the existence of hedge funds. The economics profession has no clear idea of how hedge funds will exploit disorderly markets or of how they can be constrained. This problem is not one of morality since hedge funds can be expected to do, much more quickly and more efficiently, exactly what private citizens will do when they reduce the proportion of dollar-denominated assets in their portfolios. The second development, which has implications for the capacity for disorder in foreign exchange markets, is equally unknown. It derives from the large numbers of affiliates of multinational corporations, which currently exist. The tangible assets of multinationals are difficult and costly to sell and are, therefore, not included in the value of easily encashable claims. Working capital must, however, be included. All multinational firms and most affiliates have departments which control working capital so that its costs are minimized. The goals of individual affiliates and parent corporations may not be identical but departments of working capital management are ideally placed and trained to focus on the cost of capital and to be aware of developments in foreign exchange markets. Indications of a potentially large disturbance in foreign-exchange markets could generate defensive, destabilizing measures.

To avoid a currency crisis in the U.S., confidence in dollar-denominated securities must be maintained

⁶ Strangely, the limits were originally defined quite precisely with no institution being given contracyclical discretion so that the maximum ratio of fiscal deficit to GDP could be increased for all members simultaneously if global conditions warranted. This omission is probably an indication of the difficulties of negotiating the Treaty of Maastricht.

Conclusion

The argument of this paper is based on the presumption that, sooner or later, the growing net indebtedness of the US economy to residents of other countries will trigger a severe currency crisis. The remedy for the crisis will be for the United States to apply measures to reduce its current deficit to tolerable amounts and, ultimately, to generate a surplus. This process will create substantial adjustment costs in nearly all nations involved in the global economy as resources are transferred among sectors. These costs will be most burdensome in the deficit country, which must reduce its standard of living by roughly the ratio of its excess spending to its income (the ratio of the deficit to gross domestic product).

If the corrective measures can begin to be applied before the global economy confronts crisis, the adjustment process will be less severe. There is, however, little cause for optimism. Both the annual deficit of the federal government and US current deficit are at record levels and the record of the recently re-elected President is that his administration will not heed macro-financial constraints before it is forced to. The major problem is not confined to the United States. Peterson (2004, p. 36) quotes Lady Thatcher to the effect that heads of government are not willing to impose unpopular fiscal/monetary constraints on their domestic economies when the needed adjustment can be postponed to a later generation of office-holders. The unanswered and unanswerable question is whether the inevitable recession will be sufficiently deep for the global economy to lapse from the generally satisfactory record of achievement of more than fifty years' duration.

Policymakers, who will be required to handle this problem when it comes to a head, must recognize that the existing sources of stress resemble those that existed in the 1920s and 1930s with all of the hardships and dislocation that they brought. World War I destroyed the régime that existed up to 1914 (Gray 2004, pp. 16–24). The reign of sterling as the key-currency was destroyed when the British economy tried to return to the gold standard at the pre-war exchange rate of one pound sterling worth almost \$5 (4.86). This decision neglected the much greater wartime inflation in the United Kingdom than in the United States, the sale of overseas assets by the United Kingdom and the user cost on the British stock of productive capital during the war. The mon-

etary commitment required high rates of interest in the United Kingdom which handicapped the regeneration of that country's productive sector. During this time, the United States retreated into isolationism and the global economy foundered with no key-currency to lead it. The key-currency of the past sixty years is now on the point of exhausting its capacity to inspire the necessary degree of confidence.

The world must learn from history and recognize the stress placed on key-currency nations. The modern world has created two and worn them both out. Policies were not all-wise in either the United Kingdom at the end of WW I or in the United States in recent years. The record does suggest that any architecture that uses as the global reserve-currency, a currency which also serves as a national or a bloc currency, has only finite capability. When the nations of the world decide to or are forced to confront the exhaustion of the dollar, it seems that *Proposals for an International Clearing Union* (1943),⁷ which divorces the role of key-currency from a national currency, must be required reading.

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⁷ Because of J. M. Keynes's major role in its formulation, this was commonly called "The Keynes plan" (Grubel 1984, p. 12).

Chances are poor that the U.S., the key-currency country, will adopt corrective measures in time to avoid a severe currency crisis