Mario Einaudi
Center for
International
Studies

No. 2-07

Working Paper Series

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May 2007

Mario Einaudi Center for International Studies • www.einaudi.cornell.edu
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by

David P. Calleo

Abstract

Does America's return to "twin deficits" imply an unstable dollar or a return to the "declinism" of the 1980s? Ending the Cold War and establishing the Euro did leave the dollar in a fundamentally weaker position. The Clinton administration, however, eliminated the fiscal deficit. And although the large external deficit continued to increase, it was financed to a great extent by foreign direct investment that strengthened the real economy. Since the dot.com crash, however, the dollar has depended on more official and less stable forms of support – mostly portfolio investments from Japanese and Chinese central banks. In the longer term, given the difficulties of adjusting Western living standards to Asian competition, a global system of floating currency blocs seems probable. The U.S. is unlikely to maintain its dominant position by converting the "war on terror" into a geopolitical alliance comparable to the Cold War.

About the Author

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Return of the Twin Deficits: Consequences for the Dollar and the Economy

After World War II, Americans soon got used to the idea that the U.S. was the predominant power and indispensable leader of the capitalist world. By now, there are several generations who have never known any other view. That view includes a special international role for the dollar – a role generally thought both to reflect America's geopolitical and economic primacy and to be an important instrument for sustaining that primacy. By the same reasoning, periodic signs of the dollar's weakness imply a corresponding decline in America's geopolitical rank. Pursuing this linkage through the various postwar "crises" of the dollar became a common interest among numerous postwar economists and foreign policy analysts. The dollar's exchange rate had been highly unstable following the "Nixon shocks" of 1971.[i] By the late 1980s, the dollar's troubles had generated a "declinist" school of historians and political economists who attracted widespread attention in the popular media.[ii] As several of them interpreted the dollar's instability, Reagan's America was suffering from economic "overstretch," brought on by the burdens of heavy military spending. This overstretch was embodied in the nation's egregious "twin deficits" - the fiscal deficit and the external deficit. The fiscal deficit indicated that America's federal government was spending more than its income, and therefore adding to the national debt. The external deficit meant that the U.S., as an economy, was consuming and investing more than it produced, and importing the difference. By the 1980s, both these deficits had become habitual and, by historical standards, very large.[iii] The "twins" were also thought to be closely linked. In particular, the fiscal deficit, registering the government's excessive consumption or investment, was thought to exacerbate the external deficit, which registered the over-absorption of the economy as a whole.

Even if linked, the two deficits had nevertheless quite distinct effects on the dollar. The fiscal deficit could be financed by borrowing, at home or abroad, or by printing money, in other words by simply adding to the money supply, in which case the deficit would affect the dollar primarily insofar as it led to inflation. The external deficit, on the other hand, reflected our excess purchases of goods and services from abroad, and therefore had to be financed by foreigners – principally by allowing us to pay for our imported purchases with dollars. As America's external deficit continued to mount, so would the rest of the world's supply of dollars. Declinists feared that foreigners would grow nervous about holding more and more dollars. They would begin to diversify, and the dollar would start losing value – a decline that would tend to accelerate. To shore up the dollar, while continuing to run a large external deficit, the U.S. would be forced to go on raising its interest rates, which would up the price of servicing debt, dampen investment and thus choke off growth. Historians invoked the unhappy financial experiences of earlier empires. In the most popular of the declinist writings, *The Rise and Fall of the Great Powers* (1989), Yale's Paul Kennedy promised Reagan's profligate America the fate of Habsburg Spain and Bourbon France.[iv]

I myself wrote two "declinist" books. *Beyond American Hegemony* appeared in 1987 and discussed how the international monetary system had periodically been manipulated to compensate for the dollar's weakness. *The Bankrupting of America*, appearing in 1992,

discussed how big deficits linked to geopolitical over-commitment, disturbed capital markets and led to economic damage and decline.[v]

Before going on to discuss what has been happening to the international monetary system *after* the Cold War, it is instructive to review broadly how it progressed *during* the Cold War. The initial postwar monetary system, the Bretton Woods system, came into practical effect in 1958 and lasted until 1971. Technically, Bretton Woods was a "gold-exchange standard." This meant that it had fixed exchange rates and "reserve" currencies – principally the dollar – which other countries were expected to accept as a substitute for gold. While other currencies might, when appropriate, adjust their exchange rates against the dollar, the dollar itself was expected to maintain a fixed ratio to gold. And the U.S. was supposed to have enough gold to pay off foreigners who chose to cash in their surplus dollars.[vi] Already by 1958, however, the dollars held in foreign central banks exceeded America's gold reserves. The ratio continued to deteriorate throughout the 1960s.[vii] The U.S. was nevertheless determined to defend the dollar's official parity, on the grounds that it symbolized America's geopolitical strength, and was the anchor of the international financial system. Foreigners accumulating more dollars than they wanted were pressed to "revalue" their own currencies -- a step few were willing to take. For a time, political pressure discouraged our major creditors – Germany, Japan, and Canada – from cashing in their dollar reserves. Germany and Japan, of course, had substantial garrisons stationed on their territories and depended on the U.S. for their military security. Under the circumstances, Bretton Woods evolved into a system for forcing loans to the U.S. from its affluent but dependent allies. This seemed not altogether unjust – a sort of imperial tax to compensate the U.S. for its heavy spending for the defense of others.

These foreign creditors of ours were, of course, financing not only an increasing part of America's consumption and investment at home, but abroad as well. As General de Gaulle pointed out in 1965, Bretton Woods was compelling Europeans to help finance not only the Vietnam War, but also American multinationals buying up European industries. Such arrangements, de Gaulle observed, were not only "abusive" politically, but relentlessly inflationary. Under the classic gold standard, the U.S. would have been required to cover any external deficits with gold, of which it had a limited supply. Losing gold would reduce the domestic money supply in the U.S, tend to reduce purchases from abroad, and thus promote a return to equilibrium. But under the gold exchange standard, the outflow was not in gold but in paper, of which the U.S. had an infinitely elastic supply. While the export of dollars increased money supplies abroad, there was no corresponding reduction in America's own money supply at home. As a result, there was no check on America's growing tendency to run deficits. Such a system was bound to collapse, de Gaulle counseled. It would be wise to make a timely return to the gold standard – a truly multinational, rules-based system, where no monetary hegemony enjoyed "exorbitant privileges."[viii]

The Bretton Woods system collapsed in stages.[ix] In 1968, as the Vietnam War continued to rage, the weakening dollar, and the domestic inflation beginning to accompany it, forced the Johnson administration into a sharply restrictive monetary and fiscal policy along with severe capital controls, a package highly unpopular with American banking and multinational business generally. The new policy did shore up the dollar but at the price of a recession. The succeeding Nixon administration, dismayed by persistent "stagflation" and a deteriorating trade balance, and

mindful of the upcoming elections, began prodding the Fed to loosen monetary policy. Under the existing circumstances, Bretton Woods was doomed, and the administration began urgently seeking a politically palatable way to abandon it. Ideas favoring "benign neglect" of the exchange rate had already been circulating in the Johnson administration. In August, 1971, with the dollar sinking in the currency markets, Nixon abruptly embraced a new floating rate system. The fixed exchange rates of Bretton Woods gave way to the Nixon Formula – floating rates with generous monetary policy and a falling dollar.[x]

Nixon's new formula did provide immediate and flexible relief. Floating exchange rates seemed beneficial and in the short run probably were unavoidable, given the conditions of the time—the war in Vietnam, the social unrest in the U.S. and Europe, the 1973 war in the Middle East, together with the subsequent oil shocks and the deep recession of 1974. The longer-term economic results were mixed. While GDP growth did resume, the external deficit continued to worsen and the depreciated dollar remained unstable.[xi] Growing inflationary pressure was only to be expected. Nixon used temporary wage and price controls to suppress the inflation until the election of 1972. When the controls ended at the start of 1973, inflation exploded.[xii] In 1974 came the oil shocks. A quick return to monetary rigor was followed by a deep plunge into recession. Under Nixon's successor, Gerald Ford, the economy floated out of its slump and fitful prosperity returned through most of the Carter administration.[xiii]

Under Carter, the Nixon formula seemed to give the American economy and its dollar a new set of asymmetrical advantages. Since the U.S. was relatively little engaged in foreign trade, a sharply falling currency produced fewer inflationary effects in America's domestic economy than in economies where imported goods were more significant for the general price level. In effect, the U.S., thanks to its huge and still autarkic economy, had a comparative advantage in competitive devaluation. Realizing how much Europe was disadvantaged by the Nixon dollar, French President Giscard d'Estaing and German Chancellor Schmidt began planning to endow Europe with a single currency of its own. Meanwhile, the dollar continued to enjoy its old advantages. It was still the only international currency, with no serious rival in sight. As a result, it remained in demand even when American monetary policy seemed excessively expansive.

By the late Carter administration, however, major dollar inflation reappeared, with a fresh explosion of oil, gold, and commodity prices generally. World markets rose up in revolt.[xiv] The dollar began to plummet and a general financial collapse seemed imminent. Frightened by the vehemence of the reaction, Carter appointed a resolute new Chairman at the Fed, Paul Volcker. Unprecedented monetary rigor followed. The dollar was rescued from its free fall, but, as in the late 1960s or mid 1970s, at the price of a recession.[xv] In other words, stagflation returned.

Before long, however, the incoming Reagan administration had evolved a new formula. To Volcker's continuing tight monetary policy, Reagan added big tax cuts and a military buildup – in other words, an expansive fiscal policy. Very high interest rates were the result. These attracted large-inflows of foreign capital and raised the dollar's exchange rate to record levels.[xvi] In due course, the combination of very high interest and exchange rates began to have dire effects on America's competitiveness and trade balance. The radically appreciated dollar destabilized capital markets generally. The huge "recycling" oil debts, incurred by developing

countries in the inflationary 1970s, when money was cheap, were sharply revalued. Avoiding financial crashes called for increasingly urgent and generous monetary interventions. As these threatened to bring out the still virulent underlying inflation, the Fed tried to return quickly to monetary rigor.[xvii] A series of hectic booms and crashes resulted, including the severe stock market crash of 1987. By the later years of the decade, the U.S. was struggling to retreat from the consequences of its Reagan - Volcker formula by engineering a "soft landing" for the overvalued dollar.

It was in the highly troubled financial conditions of these years that declinism flourished. Since the 1960s, the dollar had moved from fixed exchange rates to floating exchange rates, from floating with easy money, under Nixon, to floating with tight money under Reagan. When one formula had exposed its weaknesses and exhausted its possibilities, another was ready. First the U.S. had exported huge quantities of dollars into world markets, then it had borrowed them back. In this way, postwar America was able to live beyond its means for several decades—to run an external deficit financed by the rest of the world. Certainly no other country could have done the same.

How was it possible for the U.S.? Surely a large part of the answer is geopolitical. The other rich capitalist countries of the world depended heavily on American military power to protect them against the Soviets. The American deficit was a kind of imperial tax needed to support America's hegemonic burdens and democratic life-style. So long as the bipolar strategic confrontation persisted, America's rich allies could not permit the dollar to crash.

If the Cold War confrontation had continued, what new formula would eventually have come along to replace Reagan – Volcker's combination of tight money and loose fiscal policy? Would the deterioration expected by the declinists have been realized? Or would some new formula have allowed the dollar's privileged position to continue? Of course, we cannot know, since the waning of the Reagan formula coincided with the Soviet collapse – a geopolitical shock that changed the whole framework of world politics. Declinism was, after all, an early casualty of the Soviet collapse. Nevertheless, we do have some basis for counter-factual speculation – for imagining what policy might have been had the Soviets survived into the new century.

We do, for a start, have some idea of where Volcker was heading. His macroeconomic principles were perhaps not so different from those of the European monetarists engendering the new Euro. He hoped that his prolonged restriction of monetary policy would "wring out" inflationary expectations.[xviii] Real interest rates could then fall and spark solid and non-inflationary growth. Real growth would ease fiscal conditions and make it easier for democracies to discipline their budgets.

Some declinists, or at least this one, looked for fiscal relief from a relative reduction in America's world hegemonic burdens – in cooperation with a resurgent Europe prepared to take the leading role in defending itself against the Soviets.[xix] Volcker, however, was much more committed to America's leading world role. He was a good Atlanticist, who believed in close cooperation with Europe, but also that the U.S. should generally take the lead in European affairs. For this reason I suspect his policy would not have succeeded in its larger goal. I never thought the U.S. could embrace orthodox views of fiscal and monetary equilibrium without a

serious adjustment of geopolitical roles with Europe. Fiscal balance would require, I thought, a better geopolitical balance. As it happened, the end of the Cold War, by radically altering the geopolitical framework, did offer the U.S. the chance for a balanced fiscal and monetary policy oriented toward real and sustainable growth. In many respects, the Clinton administration succeeded in seizing that chance.

The most surprising achievement of the Clinton years was to eliminate the fiscal deficit.[xx] The process began as the end of the Cold War brought the U.S. a large "peace dividend." With Congress controlled by conservatives unsympathetic to expanding welfare, the peace dividend was invested in restoring the fiscal balance. This lessened government borrowing and liberated capital markets. At the same time, the boom in information technology provided a heavy incentive for private investment.[xxi] Rapid growth in the nation's GDP followed, along with a major increase in productivity. And although America's consumer debt and foreign borrowing both reached record levels, GDP growth was such that the ratio of debt to the size of the economy shrank steadily.[xxii] And while heavy investment and rapid growth, together with very low unemployment and record consumption, could easily have translated into wage and price inflation, there was little sign of either.

There were two complementary explanations for America's apparent low inflation. One, favored by Volcker's successor, Alan Greenspan, argued that even if wages did rise, costs were falling more. Thanks to high investment, productivity growth had matched rising wages with proportionately greater output. The other explanation linked low inflation to the growing trade deficit. The U.S. was buying more and more manufactures from low wage countries – from Mexico, thanks to NAFTA, and increasingly from China. Given this trend, plus rising productivity in domestic manufacturing, the American workforce was shifting out of manufacturing jobs into service jobs. These tended to pay much less and to provide little security. The Clinton administration took these trends as a means for converting the economy to high-productivity manufacturing and services. Rather than protection or lengthy unemployment benefits, its preferred response to job losses was more workforce training and education in general. Welfare reform was also a favorite project - for the administration as well as for the conservative Congress. Reform made unemployment uncomfortable. Redundant industrial workers were forced into low paying service jobs. Income inequality therefore widened well beyond continental European standards, but the U.S. also avoided Europe's very high unemployment. But even near full employment, inflation was contained. Low-cost foreign manufactures were so prominent in the American market that domestic manufacturers were in no position to raise prices, nor were their workers in any position to exact big wage increases. Even workers stuck in low-income jobs did, of course, benefit from the lower cost of many manufactured items, thanks to the foreign competition that had annihilated so many well-paid manufacturing jobs in the U.S. itself. In short, the keys to Clinton's economic success were peace in the world, fiscal restraint including welfare reform, liberal trade, and heavy investment yielding higher productivity.[xxiii]

While Clinton's liberal formula eliminated the fiscal deficit, it also encouraged further the already large current-account deficit inherited from the Reagan era. In Clinton's time, however, financing that deficit seemed more a source of economic strength than vulnerability. A record wave of foreign private direct investment flowed into America's booming high

technology industries, and covered roughly 85% of the external deficit.[xxiv] Heavy private portfolio investment from abroad was more than enough to cover the rest. Hence, the foreign inflows of the Clinton era, invested directly into the real economy, contributed not to American debt but to America's real economic growth. Dollar thus remained strong, although not at the exaggeratedly high levels of the Reagan years.[xxv]

The Clinton administration seemed to be creating an American economy remarkably well adapted to the post-Cold-War world. True, there was a huge external deficit.[xxvi] Nevertheless, the dollar was strong. But, unlike in earlier formulas, the dollar did not rely ultimately on the "exorbitant privileges" flowing from America's geopolitical preeminence. The dollar's strength was economic rather than political. Direct foreign investment flowed in because the U.S. held a decisive lead in those new industries and services that were expected to dominate the coming era. That lead depended not only on the country's advanced firms but also on its abundance of excellent universities and research centers.

There were, however, less reassuring elements associated with the Clinton model. One was a tendency toward "asset inflation." [xxvii]The other was the very low rate of private saving.[xxviii] Arguably, both made it impossible for the Clinton model to continue. Asset inflation seemed evident in the celebrated dot-com boom. The widely expected stock market crash came in 2001, at the start of the new Bush administration. The Fed quickly countered with a flood of fresh liquidity, followed by Bush's large tax cuts to redistribute Clinton's promised fiscal surplus.[xxix] Consumer spending quickly recovered and the recession was mild and brief.

The crash did, however, frighten away many of those private foreign investors who previously fueled the boom. The dollar fell sharply against the Euro.[xxx] By 2003 inflows of foreign private direct investment had fallen to one-fifth of their value in 2000. Foreign central banks began intervening. When private investment resumed – in 2005 – the balance had shifted to short-term investment. Indeed, between 2002-2006, foreign holdings of U.S. assets rose 60% - from $7.8 trillion to $12.5 trillion. But whereas private direct investment grew by 38% over this period, holdings of treasury securities rose by 66%, credit market instruments by 73%, time and savings deposits by 109%, municipal securities by 195%, and non-Treasury government agency securities by 203%. FDI dropped from 19% of the foreign asset portfolio in 2002 to 16% in 2006.[xxxi] Foreign inflows were no longer such a vote of confidence in America's real economy. Nor did foreign capital contribute so directly to the growth of the real economy.

Indeed, a good part of today's inflows come from the central banks of Japan and China – America's principal foreign suppliers.[xxxii] Both countries, by supporting the dollar, are subsidizing their own exports to the U.S. For Japan, this is an old habit going back to the "dirty-floating" of the 1970s–a common Japanese and European response to Nixon's falling dollar. For a stagnant but very rich and well-developed country, like Japan, supporting the dollar to boost exports is perhaps not an irrational policy. For a poor country like China, however, it seems less sustainable. While China's rapid growth has depended heavily on its export markets, growing protectionism against Chinese products, together with mounting social unrest in China itself, pressures the government in Beijing to develop China's own infrastructure and immense home market. Under these circumstances, expecting China to go on indefinitely accumulating vast quantities of surplus dollars seems an uncertain prospect. Thus many financial analysts foresee a

sharp fall in the exchange rate of the dollar.[xxxiii] If it continues, it will bring a general decline in America's standard of living and might easily translate into a wave of protectionism around the world.

Speculations like these suggest a certain revival of old-fashioned declinism – repeating in this decade the patterns of the late 1960s, the late 1970s or the late 1980s. Declinism has recurred whenever the prevailing formula for supporting the dollar has been collapsing and nothing has yet arisen to take its place. In the past, however, a successful new formula was always found. Why should it not be found now?

This brings us to a second dubious feature of the Clinton formula – America's very low rate of personal saving. This is, of course, merely the reciprocal of what seemed a key element in Clinton's success – strong demand from the American consumer. In Clinton's time, however, the high level of private consumption was coupled with the administration's dramatic return to fiscal balance. Now, however, the fiscal deficit has returned.[xxxiv] Spending on national security is again the pivotal element. Meanwhile, demography pressed heavily on the civilian budget.

Nevertheless, consumption has held up well and continues to fuel growth. In 2006, for example, growth so lifted government revenues that the much enlarged budget deficit was only 1.9% of GDP.[xxxv] The U.S. economy seemed to have become one of those magic machines that make bread out of stones. The more we consumed and borrowed investment from more frugal neighbors abroad, the more we grew. The more we grew, the more our debts shrank in relation to our wealth.

Today, however, a number of signs suggest that our consumption-based pattern of GDP growth is unsustainable. In recent years, rising consumer spending has depended heavily on the real estate boom. A very large part of America's gross fixed investment has been going into residential construction – 75% in 2003, 29% in 2004, and 50% in 2005.[xxxvi] Generous home equity loans have regularly transformed rising property values into consumption. The housing bubble is, of course, closely linked to the economy's underlying inclination towards asset inflation. Expanding cheap credit has served as a substitute for saving. Monetary policy has been kept extremely loose since September 2001. [xxxvii] Monetary figures help to explain the rapid expansion of the mortgage market, the construction driven investment boom, and the easy availability of funds for further consumption and consumption-driven growth. Monetary inflation is, however, poorly reflected in the CPI measurement of inflation, which does not include housing prices.[xxxviii]

Considering the place of housing in America's investment figures suggests a further reflection: not all investment makes an equal contribution to productive growth. Of particular importance is investment in the research and the development of new products. Over the past decade, recent figures are not as encouraging as they might be. While federal support for R&D has remained stable, annual R&D spending of private industry in the U.S. has fallen roughly 10% since 2000.[xxxix]

But to return to housing and consumption-led growth: Today, the housing market appears to be growing saturated. Housing prices have been stagnant or falling in many parts of

the country and the recent turmoil in the sub-prime loan market has already started to depress housing prices further. Falling house prices and higher interest rates will curtail the use of home equity loans. As interest rates rise, the large proportion of adjustable-rate mortgages will put consumer budgets under growing pressure.

The general thrust of these random observations should, I think, be clear. Clinton's once highly successful economic formula for sustaining the dollar may be finishing its course. Once more, as in the later years of the Cold War, American economic strength depends heavily on geopolitics.

Today's geopolitical framework, however, is very different. In the Cold War, America and its creditors shared a common overriding threat. Today there is no single threat, but a multiplicity of local and regional struggles. Since 9/11, the attempt to gather these dispersed conflicts into a collective "war on terror" has not proved convincing. The implications are not encouraging. Financially we are increasingly dependent on the behavior of other major powers in the world. At the same time, our own interests and theirs are increasingly divergent. This is partly because we have grown habituated to living beyond our means at their expense. Since our affluent partners no longer depend on us for their security, they may grow tired of supporting our imperial lifestyle. Returning to balance with the rest of the world would no doubt be painful, for us and for others. We may well be powerful enough to delay the adjustment, probably at the expense of further alienating our world partners, Europeans in particular. We should not, however, overdo it. Our unpopularity in the world should be a cause for deep concern.

What isolates us more than anything else is our belligerent geopolitical vision. When the bipolar world came to an end, the American political imagination projected a unipolar future. With the Soviet downfall, all the world was expected to become capitalist and democratic. In such a world, America's post-Soviet predominance would be truly global.

There were, of course, alternative views. Others saw the collapse of the bipolar system pointing toward a more plural system – one, where rising Asian giants would figure more prominently, where Europe would accelerate its union, where Muslim nations would grow more assertive, or where a different Russia would be available for new geopolitical combinations.

How do these grand speculations relate to the dollar? Logically, the end of the Cold War greatly reduces the strategic imperative compelling others to sustain the dollar. The dollar's special privileges and predominant position grow increasingly anomalous. It does not seem surprising that the European Union, led by France and Germany, had the new Euro in place before the turn of the century. Thus, the dollar has now lost two of its principal structural defenses – America's Cold War strategic role and the absence of a rival currency.

Throughout most of the 1990s, the Clinton administration compensated by rejuvenating American economic policy. The US was undeniably the most successful of the major capitalist economies. Our stellar economic performance became the most convincing evidence of a unipolar world. But, as we have now learned, our unipolar vision has its dark side and has now led us astray. As a result, we have made enemies everywhere and launched ourselves into a new era of overstretch.

Doubtless, we shall once more surmount our decline. But lasting success will require adjusting to a new geopolitical reality – a plural world of several powers. To bring order to that system requires multilateral and rules-based structures - institutions that engage states in seeking the general interest, and head off disputes before they become unmanageable. A plural world might continue with a single global currency, but not the unilateral management of it. With luck and skill we may be *primus inter pares* in such a world, but not if we cling obstinately to our daydreams of unilateral predominance. In any event, given the difficulties of absorbing China and India into a closely integrated global system, or adjusting the United States and Europe to declining standards of living, we are more likely to see several major currencies and blocs. The trick will be to sustain reasonable cooperation and harmony among these sub-systems. The overriding challenge will be to take a world order that is plural, and make it collegial.

i

The table below shows the DM/ USD rate over the period 1970-1990.

	1971	1973	1983	1990
DM per USD	3.2687216	2.65752478	2.5539	1.6616

Source: "International Statistics: Exchange Rates" *The Economic Report of the President* (Washington, DC: U.S. Government Printing Office, 1978, 1980, 2000)

ii

See Peter Schmeisser, "Taking Stock: Is America in Decline?," *New York Times Magazine*, 17 April 1988, p. 96ff.

iii

The Reagan-era deficit peaked at 6.1% of GDP, a level that had not been seen since the immediate aftermath of World War II. See *The Economic Report of the President* (Washington, DC: U.S. Government Printing Office, 2007), table B79.

iv

Paul Kennedy, *The Rise and Fall of Great Powers* (New York: Random House, 1987)

v

David P. Calleo, *Beyond American Hegemony* (New York: Basic Books, 1987), and *The Bankrupting of America* (New York: Morrow, 1992)

vi

One potential flaw in this system was the existence of the parallel private gold markets in London. As demand for gold increased against a static supply, the market price of gold crept above the $35/oz level set by Bretton Woods. This created obvious arbitrage incentives for central banks, which could still buy gold from the U.S. Federal Reserve at the Bretton Woods rate. To eliminate this temptation, which would have depleted U.S. gold reserves, the London Gold Pool was established in 1960 as a collective action of European central banks and the Federal Reserve. They agreed to use their gold stores to maintain the private market price at $35.20, the cost of gold plus shipping from the U.S. to London. The pool only lasted a few years, however, before the actions of Charles de Gaulle began to undermine the gold exchange standard. See Barry Eichengreen, "Global Imbalances and the Lessons from Bretton Woods", *Économie Internationale*, no. 100, 2004. At http://www.cairn.info/article.php?ID_REVUE=ECOI&ID_NUMPUBLIE=ECOI_100&ID_ARTICLE=ECOI_100_0039.

vii

As the IMF notes,

> In 1966, foreign central banks and governments held over 14 billion U.S. dollars. The United States had $13.2 billion in gold reserves, but only $3.2 billion of that was available to cover foreign dollar holdings. The rest was needed to cover domestic holdings.

See "The System In Crisis (1959-1971)", at http://www.imf.org/external/np/exr/center/mm/eng/mm_sc_03.htm.

viii

Charles de Gaulle, *Memoirs of Hope: Renewal (1956-62) and Endeavour (1962-)*, Terence Kilmartin, trans. (London: Weidenfield and Nicolson, 1971). See also his economic advisor, Jacques Rueff, *The Monetary Sin of the West*, trans. Roger Glémet, (New York: Macmillan, 1972).

ix

Helping to fuel the collapse of the system was the growth of the Eurodollar markets, vast offshore currency markets that traded dollars independent of regulation by the Federal Reserve. The system began as early as 1957, and grew rapidly as chronic U.S. current account deficits pumped large volumes of dollars into global markets. Among their

uses was as an escape from the post-World War II exchange controls that kept the Bretton Woods exchange rates stable. For a history of the early period of the Eurodollar market, see Catherine R. Schenk, “The Origins of the Eurodollar Market in London”, *Explorations in Economic History*, 35, pp221-238 (1998).

x

The Federal Reserve Chairman whom Nixon appointed was Arthur Burns, a distinguished economist. They had collaborated during the Eisenhower administration, when Burns was Chairman of the Council of Economic Advisors and Nixon the Vice President. Both had favored tax cuts to stimulate the economy. See Robert L. Hetzel, “Arthur Burns and Inflation.”, *Economic Quarterly*, 84(1), Winter 1998 (Richmond: Federal Reserve Bank of Richmond, 1998). See also Herbert Stein, *The Fiscal Revolution in America* (Chicago and London, University of Chicago Press, 1969).

xi

The U.S. current account balance moved from a $2.3 billion surplus in 1970 to a $5.8 billion deficit by 1973. From there, it moved dramatically back into positive territory by 1975, at $18.1 billion, before deteriorating again to a deficit of $15.1 billion by 1978. Through this time, the exchange rate remained unstable. The dollar fell 25% against the deutschmark between 1971 and 1974, then appreciated 7% in 1975 before beginning another long decline until 1980. In total, the dollar ended 1980 down 40% from its 1971 value. See *The Economic Report of the President*, 2007, *op. cit.*, table B103, and *The Economic Report of the President*, (Washington, DC: U.S. Government Printing Office, 1978, 1980), tables B96 (1978) and B98 (1980).

xii

Between the first oil shock of 1973 and 1982, annual increases of the CPI index consistently exceeded 5%, with peaks in 1974 (12.3%) and 1979-81 (8.9-13.3%). See *The Economic Report of the President*, 2007, *op. cit.*, table B64.

xiii

After negative real growth in the 1974-75 recession, GDP recovered under Carter, growing at annual rates of 3-6% between 1976 and 1980. See *The Economic Report of the President*, 2007, *op. cit.*, table B4.

xiv

For my early attempt to describe the Kennedy-Johnson, Nixon, and Carter management of the economy and the dollar, see David P. Calleo, *The Imperious Economy* (Cambridge, MA, Harvard University Press, 1982).

xv

Volcker in fact engineered two recessions via high interest rates. The first came in 1980, following an increase in the federal funds rate from 7.9% to 13.4%, and saw the economy shrink 0.2%. The second arrived after the federal funds rate was further raised to 16.4%, and was more severe, with a shrinking of 1.9%, the deepest recession since World War II. See *The Economic Report of the President*, 2007, *op. cit.* table B73.

xvi

Some had prescribed this course of action much earlier. As early as 1971, Robert Mundell criticized Nixon’s tight fiscal policy and loose monetary policy as the wrong policy mix for the U.S. economy. Rather, what was needed was fiscal stimulus and monetary rigor to both fight inflation and stave off recessions. See Robert Mundell, “The Dollar and the Policy Mix”, *Essays in International Finance*, no. 85, May 1971.

xvii

After the very high rates of the early 1980s, the federal funds rate had fallen by more than half, to a decade low of 6.7% in 1986. By 1989, however, it had risen nearly three points, to 9.2%, as the Fed sought once again to cool down the speculative excesses of the late 1980s. See *The Economic Report of the President*, 2007, *op. cit.* table B73.

xviii

See *The Economic Report of the President* (Washington, DC: U.S. Government Printing Office, 1980), pp. 54-55, and Paul Volcker, *Federal Reserve Bulletin 65* (November 1979), pp. 888-889.

xix

Beyond American Hegemony, *op. cit.*

xx

The U.S. budget switched from deficit to surplus after 1996. Clinton left office in 2000 projecting a budget surplus of $166 billion for that year and $184 billion for 2001. *The Economic Report of the President* (Washington, DC: U.S. Government Printing Office, 2000) pp.397.

xxi

Notably, while housing prices continued to rise, the share of housing investment in the economy remained relatively constant throughout the 1990s, at 21-22% of total private fixed investment. After 2000, this number rose rapidly, reaching 27.5% in 2005. See *The Economic Report of the President*, 2007, *op. cit.*, table B18.

xxii

The total public debt of the United States shrank as a percentage of GDP throughout the Clinton administration, from 49.39% in 1993 to 33.20% in 2001, the year after Clinton's departure. Under Bush, that number has crept up again, and as of 2006 stood at 37.5%. See The Economist Intelligence Unit (EIU), the United States of America, Country Data 1980-present, EIU Limited, London, 2006, at www.eiu.com. Retrieved 1 February 2007.

xxiii

The low inflation during the 1990s growth cycle was puzzling from the start. Early on, unemployment fell below the NAIRU (Non-Accelerating Inflation Rate of Unemployment) but price inflation did not follow. Economists wondered whether structural changes in the economy had pushed the inflation rate lower than in past expansions. The long period of moderate inflation following the 1970s was thought to have moderated inflationary expectations and therefore wage demands. But by the second half of the 1990s, wages were rising at twice the rate of inflation, but inflation still did not accelerate.

Federal Reserve Chairman Alan Greenspan argued in the mid-1990s that the rate of technology adoption meant that U.S. productivity growth made real wage increases possible without inflation, and at the same time also led to lower unemployment.

Critics blame Greenspan's confidence about productivity gains for an easy monetary policy that allowed an asset and stock market bubble to develop. Greenspan himself seems to have recognized this danger, most famously in his 1996 "Irrational Exuberance" speech. The exuberance came to an end just as Greenspan had feared it might, with the fall of the stock market following the dot-com collapse and a wave of corporate reporting scandals. Meanwhile, high consumer indebtedness of the 1990s remained.

For Greenspan's thinking at the height of the 1990s boom, see "Statement by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Joint Economic Committee of the United States Congress," 17 June 1999, at http://www.house.gov/jec/hearings/grnspn4.htm. For critics, see Stephen S. Roach, "Think Again: Alan Greenspan", *Foreign Policy*, January / February 2005, and "Original Sin", Morgan Stanley Global Economic Forum, at http://www.morganstanley.com/GEFdata/digests/20050425-mon.html.

Later arguments gave more weight to the deflationary effects of cheap imports, Chinese in particular. As the World Bank has argued, excessive rates of private saving in China have resulted in overinvestment and overcapacity in Chinese export industries. Between 1996 and 2002, the pressure on these industries to channel their excess output into global markets has lowered Chinese export prices by an average of 15%. The result is falling prices for many consumer goods within the U.S. economy. Hence, as the volume of Chinese exports to the U.S. jumped from $15.2 to $100 billion between 1990 and 2000, the US in effect imported deflation to its economy. See World Bank (2002), "China is Becoming the World's Manufacturing Powerhouse." *Transition Newsletter*. See also Denise Yang, "China: Exporting More Deflation," *Global Economic Forum* (New York: Morgan Stanley, 2002).

Critics of this view note that much of the Chinese import growth came at the expense of equally cheap imports from other developing economies. Therefore, given the already-high volume of consumer goods imported from Asia, the deflationary impact of these imports should already have been present in the US economy. For skepticism about

China's disinflationary effect, see Steven B. Kamin, Mario Marazzi, and John W. Schindler, "Is China 'Exporting Deflation'?" *International Finance Discussion Paper 791* (Washington, DC: Board of Governors of the Federal Reserve System, 2004) and "Deflation: Determinants, Risks, and Policy Options – Findings of an Interdepartmental Task Force" (Washington, DC: International Monetary Fund, 2003).

The reports of the Council of Economic Advisers argued that falling import prices did lower inflationary expectations, but only by 0.3 percentage points. See *The Economic Report of the President* (Washington, DC: United States Government Printing Office, 1997, 1998, 1999).

Other studies suggest China's deflationary effect may be greater than previously thought, thanks to the changing nature of US retailing, in particular to the role of giant firms like Wal-Mart that import heavily from China. A recent study from the National Bureau of Economic Research estimates that the effect of Wal-Mart's "everyday low prices" on local grocery markets was underestimated by 14-18.3%. Correcting for this in the Consumer Price Index would have lowered the official estimate of inflation by 15%!

For Wal-Mart's operations and their effects on inflation, see Anthony Bianco and Wendy Zellner, "Is Wal-Mart too Powerful?" *Businesss Week*, 6 October 2003, p100, and Gene Koretz, "Wal-Mart versus Inflation", *Business Week*, 13 May 2002, p32. For evidence of methodological bias in CPI calculations stemming from undercounting the effect of big-box stores, see Jerry Hausman and Ephraim Leibtag, "CPI Bias from Supercenters: Does the BLS know that Wal-Mart Exists?", *NBER Working Papers,* no. 10712, (Cambridge: National Bureau for Economic Research, 2004).

xxiv

From 1993-2000, the U.S. accumulated nominal liabilities from the annual current account deficits equivalent to $1.335 trillion. In return, the U.S. received 85% of that, or $1.137 trillion, in foreign direct investment. Foreigners invested another $1.136 trillion in corporate equities and bonds, more than covering the remainder. In total, FDI made up 27% of the net asset acquisitions of foreigners in the United States during this period. In comparison, official foreign government purchases of Treasury securities accounted for a mere 6% of total financial inflows.

In contrast, during the 2001-2005 period, the accumulated liabilities of the current account deficit equaled $3.6 trillion, but FDI accounted for only 21% of that, or $758 billion. Adding corporate equities and securities still leaves $861 billion to account for. To cover this gap, foreign purchases of Treasury securities picked up, with official foreign holdings increasing by $734 billion and private holdings $465 billion, or 11.9% and 7.5% of total financial inflows, respectively.

In summary, after 2000, the U.S. was more reliant on foreign government purchases of U.S. sovereign debt to cover its current account balance, whereas in the 1993-2000 period, private fixed and portfolio investment were sufficient to cover it.

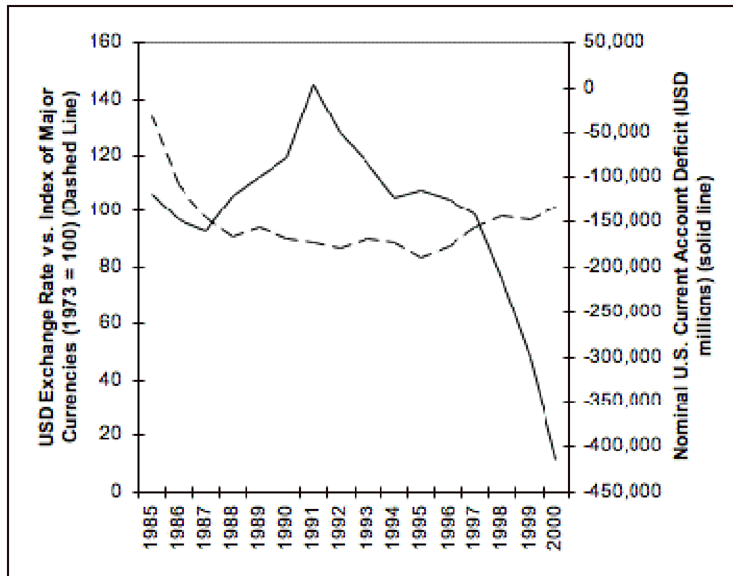
See "Flow of Funds Accounts of the United States: Annual Flows and Outstandings", 1985-1994 and 1994-2005 (Washington, DC: Board of Governors of the Federal Reserve System, 2007), table F.107.

xxv

For an exploration of the magnitude of transatlantic FDI from the early 1990s onward, see Daniel S. Hamilton and Joseph P. Quinlan, *The Transatlantic Economy 2006* (Washington, DC: The Center for Transatlantic Relations, 2007).

xxvi

As the figure below shows, between 1992-2000, the dollar regained most of the ground lost during the economic uncertainty of the late 1980s. With that, however, came substantial growth in the current account deficit.



Source: *Economic Report of the President*, 2007, *op. cit.*, tables B103 and B110.

xxvii

The Clinton administration argued that the fall in the federal deficit made possible higher private investment without raising interest rates. Continuing low interest rates also made possible booming real estate and asset prices. For a neo-classical economist like Friedrich Hayek, booming corporate profits with a concomitant rise in stock prices is an early sign of inflation. Rising profits and asset prices become an embedded expectation, which cannot be satisfied except by increasing inflation.

For Hayek's thoughts on asset inflation, see Friedrich A. Hayek, *The Constitution of Liberty* (Chicago: University of Chicago Press, 1978), pp. 331-332.

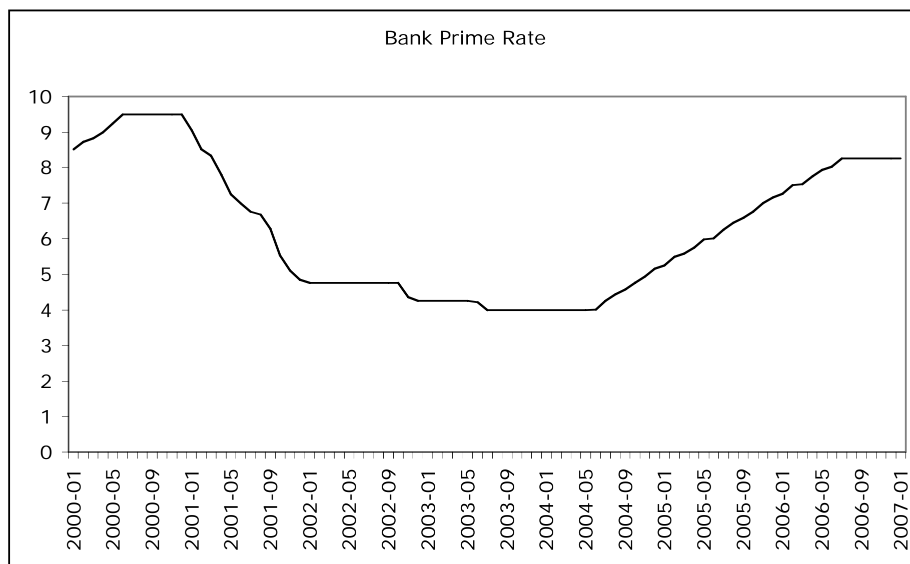
xxviii

The US entered the 1990s with a household savings rate as a percentage of disposable income of 7%. This steadily declined and the U.S. entered the new century with a savings rate of 2.3%. On average, Americans in the 1990s saved 5.2% of their disposable income. In comparison, the Japanese saved 13.9% of disposable income in 1990 and 10.7% in 2000, and the Germans 13.9% and 9.5%, respectively.

See "Macroeconomic Trends: Economic Growth: Household Saving", in *OECD Factbook 2006: Economic, Environmental, and Social Statistics*, available at http://lysander.sourceoecd.org/vl=8881248/cl=13/nw=1/rpsv/factbook/. Copyright OECD 2006. Retrieved 29 January 2007.

xxix

As the graph below suggests, the prime rate plummeted after 2001 and remained low for several years.



Source: Federal Reserve Bank of the United States

xxx

Between 2000-2005, the dollar fell 25% against the Euro. Similar declines were seen against the pound (-16%) and the Canadian dollar (-18.4%). See the OECD Statistics Databank, Copyright 2006.

xxxi

Inward foreign direct investment stood at $321 billion in 2000. By 2003, it dipped to $63 billion, before recovering to $110 billion in 2005. In relative terms, the Economist Intelligence Unit reports that foreign direct investment in the United States, having risen from 0.84% of GDP in 1990 to 3.27% in 2000, fell to a nadir of 0.58% in 2003 before recovering slightly to 0.88% by 2005. The Economist Intelligence Unit (EIU), Japan, the United States, and Europe, Country Data 1980-present, EIU Limited, London, 2006, at www.eiu.com. Retrieved 21 September 2006.

For the breakdown of foreign funds inflows after 2000, see the Federal Reserve Bank of the United States, "Flow of Funds Accounts of the United States", table L.107, at http://www.federalreserve.gov/releases/z1/Current/.

xxxii

The data for 2005 show Japan and China as the major holders, as the table below indicates:

Foreign Holdings of US Treasury Securities (bn USD)

Country or Entity	Jul-05	Nov-06
Japan	669.4	637.4
China	296.4	346.5
United Kingdom	73.2	223.5
Oil Exporters	64.1	97.1
Carib Bnkng Ctrs	65.2	63.6
Korea	62.6	67.7
Taiwan	58.8	63.2
Germany	44.8	52.1
Hong Kong	44.7	51.0
Mexico	32	38.2

See "Major Foreign Holders of Treasury Securities," United States Department of the Treasury, September 18, 2006, and January 20, 2007, at http://www.ustreas.gov/tic/mfh.txt

xxxiii

For indications that China is already moving this direction see Peter S. Goodman, "China Set to Reduce Exposure to U.S. Dollar", *The Washington Post*, 10 January 2006, pp D01. More recently, the Governor of the People's Bank of China remarked, "many people say that foreign exchange reserves in China are (already) large enough. We do not intend to go further and accumulate reserves." See Lucia Mutikani, "China reserve comments unsettle dollar vs. yen", Reuters News Agency, 20 March 2007, at http://www.reuters.com/article/wtMostRead/idUKT6842120070320.

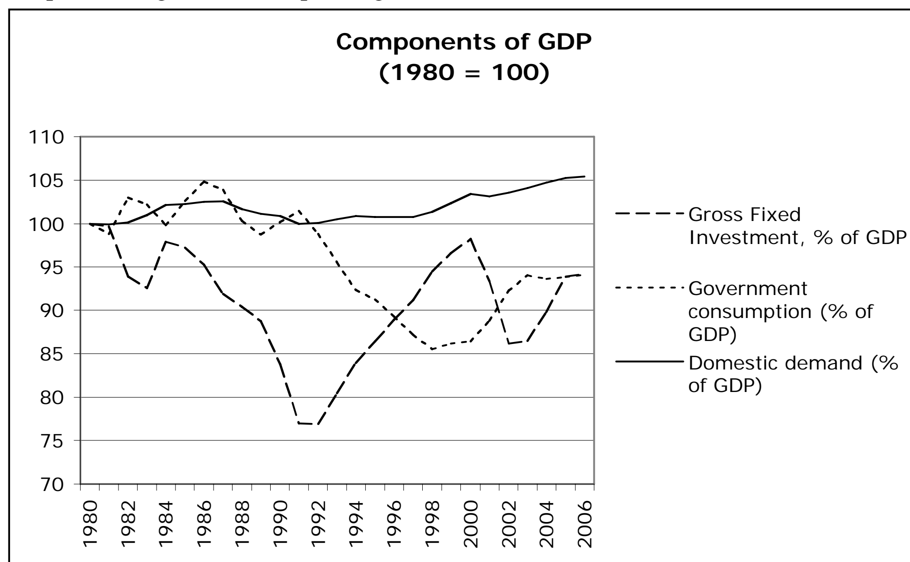
xxxiv

In its first year in office, the new Bush Administration ran a fiscal surplus of 1.3% of GDP. In subsequent years, the weight of tax cuts and security spending dragged the budget back into the red, reaching a low point with the 2004 deficit of 3.6% of GDP. It has since recovered, and the deficit now officially stands at 1.9% of GDP as of 2006. See *The Economic Report of the President*, 2007, *op. cit.*, table B79.

xxxv

The Economic Report of the President, 2007, *op. cit.*, pp. 324.

As the figure below suggests, consumption continues to play a major role in driving GDP, even as the other components – government spending and investment – have fluctuated.



Source: The Economist Intelligence Unit, Country Data for the United States. Copyright 2006, The Economist. Retrieved 1 February 2007.

xxxvi

The Economic Report of the President, 2007, *op. cit.*, table B5.

xxxvii

From 2000 to 2006, M2 increased 43% (6.1% annually; average annual inflation was 2.8% and GDP growth 3.3%). By comparison, throughout the whole of the 1990s, M2 rose only 42%, (despite comparable inflation and GDP growth figures). *ibid.*, table B69.

xxxviii

The consumer price index is designed to measure everyday expenditures, and thus excludes large capital goods like housing. "Core Inflation" further restricts the basket of goods included in the CPI by leaving fuel out. For the full definition of the CPI measure, see http://www.bls.gov/cpi/#overview.

xxxix

The latest National Science Foundation data shows relative stability in US R&D spending as a percentage of GDP, at 2.6-2.7% overall. However, while federal support has been stable, industry expenditure on R&D has fallen approximately 10% since 2000. See "National Patterns of R&D Resources: 2004 Data Update NSF 06-327" (Washington, DC: The National Science Foundation, September 2006).

Also of concern is the effect post-9/11 security measures will have on the free exchange of research information and materials. The National Academy of Science recognized this early in the War on Terror, with its 2002 "Statement on Science and Security in an Age of Terrorism," in which in called on government to maintain that "delicate balance between openness and security…that has allowed science and technology to be used to effectively to make the nation safer."