

The impact of US international debt on transatlantic economic integration

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The US external deficit is the subject of an increasingly heated academic debate. It sounds odds to many that the US, the first economy of the world, is by the same token the largest world debtor. At the end of 2004, it had net external liabilities of \$2.5 trillion, or 22 percent of GDP. The current account (goods and services, transfers, and capital income) is massively in deficit—about \$670 billion in 2004, or about 6 percent of GDP.

Whether US foreign liabilities actually stand for a serious problem or not is the object of the debate. Economists, quite unsurprisingly, hold most opposite views on the topic. It is not quite controversial that some form of adjustment of the US deficit, particularly in terms of exchange rate, will have to take place. What is questioned is whether such a “landing” will be painful and costly or gradual and smooth. Whatever opinion we side by, implications for US-Europe alliance may be significant.

On the one hand, a group of analysts, actually the majority, argue that that the US current account and budget deficit are not sustainable. In [The US as a debtor nation](#) William Cline from the Institute for International Economics points out that the US deficit is not benign as it was in the 1990s. “In the late 1990s,” Cline says, “the rising trade deficit and associated borrowing from abroad were benign, and the additional foreign resources were directed toward more investment. But now such resources largely finance US private and government consumption rather than productive investment.” Countries such as China and Japan, which have up to date financed the US deficit will not do so indefinitely. They will eventually shift part of their huge foreign reserves to other currencies. Rumors that the Chinese central bank already considers doing so are abundant. The New York Times and the Economist recently reported similar allegations. In the presence of an escalating deficit, it would be ultimately too risky investing in the USA. The pessimist scenario adds that the US economy is already overrated due to the presence of a huge real estate bubble. An inevitable fall in housing prices should follow with a consequent decline of real asset prices. Combined with the possible sensible drop of capital inflows from abroad, associated to the deteriorating US deficit, the burst of the housing bubble would result in a dramatic rise of US interest rates. In turn, that would finally trigger a painful, prolonged recession.

On the opposite side, other analysts claim that there is not a credible alternative to the US as a leading economic hegemon. This position is very well summarized by Robert Cooper's [US deficit: It is not only sustainable, it is logical](#) and by David H. Levey and Stuart S. Brown in their Foreign Affairs article [The overstretch myth](#). They mention that the US still represents the most dynamic economy of the world with high productivity growth, leading technological innovation and low unemployment. They point by contrast to the rigidity of European economy, with declining populations, high unemployment and an insufficiently integrated common market. This view also holds that the US financial market, including the bond and the equity market, would be more efficient than any other in the world and would keep offering an appealing target to international financial investors. Additionally, China and Japan would have no reason to dump the dollar. That would make their currency more valuable and their goods relatively more costly, resulting in a fall of their lucrative exports to the US.

How does the situation of the US international and budget deficit affect transatlantic relationship?

The US and Europe are each other's main trading partner and accounts, by far and large, for the bulk of world trade. The growth in transatlantic investment has been even more substantial with [US investment to Europe rising from \\$ 214,739 millions in 1990 to 963,087 millions in 2003](#). Even though EU member countries trade more among each other than with the US, if Washington suddenly decreased its volume of economic exchange with the old continent European growth, already sluggish, could be seriously hampered.

However, this danger should not be exaggerated. Diminishing American imports and investment may not necessarily hurt the transatlantic agenda. On the contrary, they could represent a strong encouragement to boost the uncertain domestic growth in Europe and absorb a higher percentage of American exports, especially in the service sector. That is actually the expectation and the auspice of many American analysts. Hamilton and Quinlan in *Deep Integration* remark that the service sector is the sleeping giant of the transatlantic economy. They point that beyond the public debate about emerging markets Europe and the USA are still the leading markets, with an escalating level of reciprocal investment. There are thus the margins for an expansion of the transatlantic economy. This view obviously implies that the US should reverse, at least partially, its current trend of overconsumption, whether private or public. The other side of the Atlantic ought to accelerate the growth of Eastern Europe and its full integration into the EU economic system.

In conclusion, we face different scenarios, not necessarily unfavorable to the transatlantic partnership. If the dollar and US imports and investment will fall rapidly, the cost of adjustment for Europe could be serious. Furthermore, domestic lobbying groups in the US could blame excessive imports for the US external balance and exert strong protectionist pressures. That would not solve the problem of US liabilities, but could result in disastrous consequences for transatlantic trade, which still has an enormous potential.

If, on the contrary, the ease of capital flows to the US and the fall in American imports will take place steadily but not suddenly, there will be room for necessary, reciprocally profitable adjustments.

In both cases, it is evident once more how important is the strengthening of institutional ties between the two sides of the Atlantic. A common framework managing a "soft landing" for US external deficit could be quite effective, if not necessary. In the first place, it would anticipate possible sudden deterioration of the situation. More importantly, a common transatlantic institution would prevent protectionist groups from taking an unfair advantage of the US deficit problems. It is important to realize that in case the worst-case scenario materializes in the US economy, panic could fuel "anti-foreigners" reactions, possible toward Europe as well.

In [Euro at Five](#), Fred Bergsten from the Institute for International Economics makes a case for a coordinated management of the euro-dollar exchange rate. The author argues for the creation of a sort of financial "G-2" mechanism. "At the very minimum the monetary authorities of the USA and Euroland need to create a new consultative arrangement to monitor the evolution of the euro-

dollar exchange rate and be prepared to recommend contingency plans to their governments if market movements become disorderly and/or overshoot. [...] It is simply inadequate for these officials, as to the present, to get together sporadically around G7 or other broader meetings- which are also complicated by the presence of other countries that are less relevant [...].” Bergsten makes clear that G-2 would not be an actual institution, but a steering committee which could also improve international financial arrangements.

Interestingly, Bergsten expects the G-2 to develop into a transatlantic agreement setting a fluctuation range for the dollar-euro exchange rate. As a matter of fact, that would be the most logical development if the transatlantic economy were to integrate ever further. The US and EU Central banks would be requested to manage the exchange rate agreement with proper sterilized intervention and also jawboning arrangements. However A closer US-EU cooperation in monetary policy would require a consolidation of the decision making process in Euroland, in particular in the field of fiscal policy, which is still subject to the unanimity rule.

An authoritative, though indirect support for a revival of a Bretton Woods-like system, comes from *The Dollar Crisis*, by former IMF analyst Richard Duncan. Duncan argues that the huge US deficit has resulted in an excess of credit in the world economy. This oversupply of money has financed overconsumption and overinvestment, causing the current financial instability. Duncan represents quite a gloomy scenario, in which the US economy overcapacity is bound to result in a sharp recession devastatingly propagating to all the economic partners of the US .

Duncan makes a case for a world managed control of the money supply. He argues that the post Bretton Woods system is inherently instable and incapable of preventing long term external deficit, with their associated financial instability. An international monetary authority could avoid such a rise in international money supply as that responsible for the current crisis. Duncan also points to the containment of external deficits, which are associated to the capital inflows needed to finance the deficit. The author argues for the reintroduction of fines, originally proposed by Keynes, for countries exceeding the deficit floor. In case member countries faced shortages of capital, they could enjoy special monetary reserves. Duncan points to such reserves as the Special Drawing Rights (SDR), which already exists as a reserve monetary tool for the IMF.

The USA and Europe could well act as the original founders of this new “Bretton Woods-like” system. Their accentuated degree of integration, strongly increased in the last years, and the closer cultural and political understanding make the transatlantic allies suitable candidates to establish a new monetary order.

The institution devised for this purpose should have thus two great goals: managing the transition of the US external deficit adjustment and creating the base for an integrated transatlantic monetary policy.

Which institutional tool could do best? The G-2 idea is appealing because it does not imply the making of an organization with the power to emanate binding regulations, in a difficult moment for the US-EU alliance.

Nevertheless, managing a sustainable adjustment of the US deficit will require more a stable and reliable cooperation. We could thus take a step further and establish at least a permanent forum within an institutional framework, dealing specifically with transatlantic macroeconomic coordination.

However, it is evident that once the US and Europe have acknowledged the urgency and the importance of a common monetary framework, the choice of a proper political body should easily follow.

Setting up a subcommittee in an organization such as the OECD may be an option. The OECD provides the technical support for such a specialized issue as well as the necessary credibility and prestige. Representatives of the US and the EU central banks as well as respective Finance Ministers should be members. Regardless of the technical composition, this institution should:

- Monitor constantly the \$/€ exchange rate fluctuation and, more in general, the impact of US external deficit on transatlantic economy;
- Formulate policy recommendations for monetary and fiscal authorities of both parties, especially about the initiatives required for a soft adjustment of the US deficit;
- *In a following, bolder step, start **elaborating a sound agreement for a fixed fluctuation range of the \$/€ exchange rate and for a controlled system of transatlantic money supply***;
- Once such an agreement is established, oversee its implementation and study the realization of an even greater integration. A logical, though ambitious development should be the making of a common, quasi-federal institution, such as the European Commission is for the EU, stably and definitively setting the money supply of both sides of the Atlantic.

The very near future represents a challenge to this ambitious program. In any event, we see no serious and valuable alternative to a common management of transatlantic macroeconomic policy. The collapse of the Bretton Woods system has ultimately resulted in the current, unsustainable monetary and financial instability. The degree of integration of the world economy grew enormously since the 70s. A global economy cannot work under totally separated macroeconomic policies.

Disagreements between the USA and Europe convicted Bretton Woods. A new understanding between Bruxelles and Washington can revive it. A common monetary framework in the transatlantic relationship is much more likely to succeed today than in the 70s. Today we have both more a solid monetary background and a more compelling need to act.

The background is given by the presence of the Euro and a common European monetary policy, which did not exist in the 70s. Europe now speaks with one voice in this field and that would make a common rule of monetary policy much more feasible.

The compelling need to take action stems from the situation of the US liabilities. US trade deficit and external debts struck record limits, completely unthinkable in the 70s. Even if the optimists got it right and the adjustment of the US deficit were quietly manageable, we simply cannot run

the risk of the opposite outcome, resulting in a disruption of the transatlantic economic order. The USA and Europe have the incredible opportunity to seize this chance. And should do it soon.

Relevant Bibliography

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