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THE UNSUSTAINABLE INTERNATIONAL ECONOMIC POSITION OF THE UNITED STATES AND THE BUDGET DEFICIT

WASHINGTON—The US current account deficit is likely to soar to more than \$5 trillion annually by 2030, compared with a record high to date of \$700 billion in 2006, if corrective action is not taken to reduce the size of future budget deficits. This means that the current account deficit would reach more than 15 percent of the total economy, against the previous record of 6 percent, according to new projections from the Peterson Institute for International Economics. As a result, the net foreign debt of the United States would rise to \$50 trillion and 140 percent of GDP—far above any conceivably sustainable positions. Were the current trend to continue, the nation would be transferring about 7 percent of GDP annually to foreigners by 2030 to service its huge international debt. These forecasts are based on the most likely long-term scenario for the US and world economies including continued high levels of the US budget deficit.

The United States would face cataclysmic economic adjustments under anything approaching this outcome. The global loss of confidence in American solvency would lead to a crash in the dollar with sharp inflation pressures and skyrocketing interest rates. The government would have to carry out dramatic spending cuts, including severe reductions in health and pension payments for retirees, and drastic tax increases. If preventive action is not taken, the forced adjustment to the huge external deficits would require the United States to cut domestic spending (private consumption, investment and government programs) by at least 13 percent of GDP annually; by contrast, US domestic demand has fallen by only about 3.5 percent in the present deep recession. The result would be prolonged stagflation or worse.

This path is so unsustainable and dangerous that a crisis would be virtually certain to occur long before the United States reached such a painful point of reckoning. The projected numbers are far above the recent highs of \$700 billion and 6 percent of GDP for the annual US current account deficit, and \$5 trillion and 30 percent of GDP for US foreign debt. They are far beyond the widely accepted “danger thresholds” of 3–4 and 40–50 percent of GDP, respectively, which historically have been markers of financial crisis risks for indebted economies.

The chief policy implication is the need to act as soon as possible after the current recession ends to restore balance in the US fiscal position. This would reduce US demand for foreign funds to finance our deficits, keep the dollar from rising again to uncompetitive levels, and hence avoid an escalating level of external deficits and debt. As difficult as such steps

might be, failure to act will virtually guarantee a dramatic erosion of the US international economic and financial position. Effective action to correct the budget deficit will have to include reform of the major federal entitlement programs.

These are the major findings of *The Long-Term International Economic Position of the United States*, edited by C. Fred Bergsten, a new analysis conducted by the Peterson Institute for International Economics with support from the Peter G. Peterson Foundation. The conclusions come at a time when many in Congress and the Obama administration, and especially the private financial markets, have begun to warn of mounting budget deficits and government debt. The new study provides strong support for these concerns by supplying detailed projections for the US current account and international investment position to 2030, by Senior Fellow William R. Cline, and relating these external considerations to the budget deficits.

Dr. Cline projects the outlook for the US current account on the basis of two alternative assumptions concerning the US fiscal position: a “benign baseline” in which the budget deficit returns promptly after recovery to a level of 2 percent of GDP and a “fiscal erosion scenario,” which seems much more likely, under which spending increases—largely driven by Medicare, Medicaid and Social Security—push the fiscal deficit back to 10 percent of GDP by 2030. Under the erosion assumption, which will happen in the absence of policy changes according to the Congressional Budget Office, the current account imbalance reaches 15 to 25 percent of GDP in 2030. Even with the “benign baseline,” which would incorporate major reforms of all the large entitlement programs, the US current account deficit and net foreign debt rise to uncomfortable levels of 6 and 70 percent of GDP, respectively, by 2030. But the difference of 8 percentage points in fiscal deficits between the two scenarios would have an enormous impact on the US international position because it would sharply increase domestic spending and thus imports of both goods and capital.

The attached table 1 reproduces Cline’s results on the much more likely “fiscal erosion” prospects. The results show that, by 2030, the deficit in trade in goods and services reaches \$3 trillion. Net investment income transfers to foreigners exceed \$2.5 trillion, even assuming that American investments abroad continue to earn a much higher return than foreign investment in the United States. The current account deficit would exceed 15 percent of GDP. The country’s net foreign debt would climb to 140 percent of GDP. These projections assume no change in fiscal and other policies.

The prospects for external financing of deficits at these levels—including the willingness of China, Japan, the Gulf countries and other overseas investors to keep buying US Treasury securities—are highly questionable. Senior Fellow Catherine L. Mann finds that the “fiscal erosion” scenario would require that global investors breach their historical preferences for asset allocation almost immediately by allocating more than 40 cents of each dollar increase in their total portfolios, including domestic assets, to US assets. The “erosion” scenario would then over time require global investors to raise their purchases of U.S. bonds and equities from its current share of about 15 percent of their total investments to as much as 45 percent by 2030; this would represent a movement away from “home bias” toward “US bias” that is clearly unsustainable. Senior Fellow Adam S. Posen adds that these developments would raise serious concerns about the international economic and political role of the United States, including the position of the dollar.

Institute Director C. Fred Bergsten summarizes the main findings of the volume in an overview chapter, which also discusses the role of the global imbalances in creating the current economic and financial crisis. He notes that the crisis occurred at least partly because the rest of the world was *too* willing to finance large US external deficits, generating easy monetary conditions and scope for overleveraging that in essence “gave us enough rope to hang ourselves.” Hence the United States loses in a major way from excessive international deficits whether or not foreigners are willing to finance them. Dr. Bergsten concludes that the long-predicted “hard landing” (though not yet for the dollar) has clearly emerged, and that the United States is already undergoing painful adjustment via a sharp cutback in the growth (and now even the level) of domestic demand, but that much worse prospects lie ahead unless we prevent the buildup of massive external imbalances in the future by dealing decisively with the fiscal outlook as soon as recovery from the current recession permits.

Table 1 US external accounts under fiscal erosion, 2008–30 (billions of dollars and percent)

Measure	2008	2009	2010	2011	2015	2020	2025	2030
Exports, goods and services	1,836	1,687	1,720	1,944	2,782	3,828	5,255	7,210
Imports, goods and services	2,517	2,048	2,301	2,576	3,509	4,975	7,100	10,263
Oil	453	226	277	343	598	694	805	955
Trade balance, goods and services	-681	-361	-581	-632	-727	-1,147	-1,845	-3,053
Transfers ^a	-127	-125	-130	-136	-165	-208	-263	-333
Net capital income	135	56	60	14	-72	-405	-1,129	-2,549
Current account	-673	-430	-651	-755	-964	-1,760	-3,238	-5,935
Percent of GDP	-4.7	-3.1	-4.5	-4.9	-5.2	-7.5	-11.0	-15.9
External assets	13,005	13,197	14,471	15,663	18,465	21,580	25,448	30,449
External liabilities	17,397	18,009	19,256	20,728	26,300	36,576	53,618	82,630
Net international investment position	-4,392	-4,812	-4,785	-5,065	-7,835	-14,997	-28,170	-52,181
Percent of GDP	-30.8	-34.3	-32.8	-33.1	-42.4	-64.1	-95.3	-139.6
Growth (percent)								
United States	1.1	-2.6	1.9	3.0	2.75	2.75	2.75	2.75
Foreign	2.0	-0.9	2.4	4.1	3.5	3.5	3.5	3.5
Real dollars/foreign currency	1.00	0.92	1.00	1.03	1.01	0.96	0.91	0.88
Bond rate (percent)	3.7	3.0	4.0	5.1	5.7	6.3	7.0	7.4
Brent–WTI price (dollars per barrel)	100	50	60	74	129	150	174	206

a. Includes employment income.

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ABOUT THE EDITOR

C. Fred Bergsten has been director of the Peterson Institute for International Economics since its creation in 1981. He was the most widely quoted think tank economist in the world over the eight-year period 1997–2005. He testifies frequently before Congress and appears often on television. Dr. Bergsten was assistant secretary for international affairs of the US Treasury (1977–81); undersecretary for monetary affairs (1980–81), representing the United States on the G-5 Deputies and in preparing G-7 summits; assistant for international economic affairs to Dr. Henry Kissinger at the National Security Council (1969–71); and senior fellow at the Brookings Institution (1972–76), the Carnegie Endowment for International Peace (1981), and the Council on Foreign Relations (1967–68). He was chairman of the Competitiveness Policy Council, which was created by Congress, throughout its existence from 1991 to 1995; and chairman of the APEC Eminent Persons Group throughout its existence from 1993 to 1995.

This is the fortieth book that he has authored, coauthored, or edited. The latest include *China's Rise: Challenges and Opportunities* (2008), *China: The Balance Sheet—What the World Needs to Know Now about the Emerging Superpower* (2006), *The United States and the World Economy: Foreign Economic Policy for the Next Decade* (2005), and *The Dilemmas of the Dollar* (2d ed., 1996).

Dr. Bergsten has received the Meritorious Honor Award of the Department of State (1965), the Exceptional Service Award of the Treasury Department (1981), and the Legion d'Honneur from the Government of France (1985). He has been named an honorary fellow of the Chinese Academy of Social Sciences (1997). He received MA, MALD, and PhD degrees from the Fletcher School of Law and Diplomacy and a BA magna cum laude and honorary Doctor of Humane Letters from Central Methodist University.

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